XXI—1

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ACCOUNTING PRACTICE AND AUDITING

WRITTEN FOR THE ALEXANDER HAMILTON INSTITUTE

BY

JOHN THOMAS MADDEN

MODERN BUSINESS

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PREFACE

In the preparation of this volume, the author has endeavored to keep constantly in mind its relation to the other volumes of the Modern Business Text, especially those dealing with accounting. For this reason, all reference to valuation and interpretation has been avoided.

By the time the reader has reached this volume of the Modern Business Text he has become familiar with the fundamental principles of bookkeeping; he has, moreover, seen the application of these principles in Cost Finding. The special phases of Branch Accounts, Partnerships, Consignments and Joint Ventures, Corporations and Fiduciaries require separate consideration and for this reason, they have been discussed at length in so far as accounting practice is involved.

As member of the staff of the Alexander Hamilton Institute, Professor John T. Madden who has written the present Text has frequently been called upon to assist subscribers in regard to questions of accounting practice. This experience has been drawn upon in large measure with a view to including in the present volume the solution of many of the more important problems that are likely to

confront the subscribers to the Modern Business Course and Service in their reading.

The author desires to acknowledge valuable assistance received from Mr. Leo Greendlinger, M. C. S., C. P. A., both by constructive criticism and in the form of excellent suggestion.

From the standpoint of the practitioner or student of auditing, the subject of auditing is adequately treated in the excellent works of Dicksee and Montgomery, but a discussion of the subject from the viewpoint of the executive has been overlooked. The present volume attempts to supply this need and for that reason the author has explained fully the different types of engagements. The nature and character of the work which the executive may expect of his auditor are also set forth.

Here we are concerned solely with verification. Ordinarily, the executive will have no occasion personally to undertake the verification of assets and liabilities, and he will, as a rule, do well to leave such tasks to those who are by reason of training and experience better qualified to perform them. However, the rules and methods employed by practicing auditors have been stated so that the executive may, if he desires, undertake simple work of this character or so that he may at least know how one employed by him for such work should usually proceed.

THE EDITORS.

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PART I

ACCOUNTING PRACTICE

ACCOUNTING PRACTICE

CHAPTER I

PROPRIETARY ACCOUNTS

1. *Proprietorship defined.*—The excess of assets over liabilities constitutes proprietorship, or ownership. The ledger accounts that represent and measure this excess are known as the proprietary accounts. Broadly speaking, there are two general classes of undertakings. The first class consists of those undertakings in which the prime purpose is to increase the proprietary interest thru profits resulting from the employment of wealth in business enterprise. The second class consists of those undertakings in which the principal object is not to make a profit, but to render service, either to the members of the particular organization or to the community at large.

The legal phases of the various classes of undertakings, together with the legal rights and duties of the members composing them, have been fully discussed in the volume on "Business Organization."

2. *Proprietary accounts under sole ownership.*—When a sole trader begins business operations, the amount of his investment, represented by the difference between his assets and his liabilities at that time, should be credited to his capital account. If this is

done, the effect is the same as that which would have resulted from crediting the proprietor's account with the sum total of his assets, and debiting it with his liabilities. The proprietor's investment will include only those assets that are actually employed in the business; that is, he will not merge his purely personal assets with those that are used in the business. His liabilities should include only those debts which are created in carrying on the business. His capital account will thus represent his net investment. This distinction is important because, while it is proper for a sole proprietor, in furnishing a statement of his assets and liabilities for credit purposes, to include assets and liabilities which do not belong to the business, such procedure would not be proper if the proprietor were merely making a statement of the accounts of his business.

In comparing the profitableness of different business operations, the proprietor must take into consideration only the assets which have been employed in securing such profits. If he includes other assets, not employed in the business, he will reduce the ratio of earnings on the invested assets which are used in the business.

During the year, the proprietor will perhaps withdraw for his personal use either funds or merchandise. In order that a proper record may be kept of the withdrawal of such values, and in order that the proprietor may be able to determine accurately the profits which result from his business, he must charge

to a special drawing account the amounts withdrawn in cash as well as the cost of the merchandise which he may have consumed for his personal use. At the end of the period, the balance of this account should be transferred to the debit of his investment or capital account. The change in the proprietorship during the period, measured by the net loss or the net profit from business operations, at the end of the period under review, will be carried to the credit or to the debit of his capital account, according to whether they have resulted in a gain or in a loss. In order that the true profit resulting from business operations may be reflected in his accounts, the proprietor may properly charge, as an expense of the business, the reasonable value of his personal services.

A sole trader should also provide for the adequate depreciation of his fixed property during the period, by charging the amount thereof against the profits of the period. The amount of depreciation sustained will be credited either to the asset account direct or to an appropriately ear-marked reserve account. The latter method is preferable, and if followed, the reserve account should always be considered as an offset to the relevant asset. It should not be shown as a part of the proprietorship.

The proprietor may also set aside out of his profits other reserves as prudence may dictate. The use of such reserves, however, is more common in the business of partnerships and corporations. In brief, then, the proprietary interest of a sole trader will be represented

by the aggregate of his capital and salary accounts—including the reserves that may have been created, as a result of prudence and conservatism, eliminating the reserves for depreciation—minus any balance that remains in the drawing account.

The fact that the law does not recognize the business undertaking of a sole trader as an entity separate and distinct from the proprietary account, is important enough to bear repetition. If the assets of John Jones, proprietor, are not sufficient to liquidate the liabilities of John Jones, proprietor, the creditors have a right to satisfy themselves out of any other assets that John Jones may own in any other capacity. This point is important because of the fact that there is considerable discussion as to whether or not the proprietorship constitutes a liability or an accountability. While this discussion is more theoretical than practical, it may in some instances help to determine whether a business organization is solvent or insolvent. For illustration, let us assume that a corporation has assets amounting to $10,000, liabilities to outside creditors of $4000, and capital stock outstanding to the amount of $6000. Let it be assumed that at the end of the period the assets are found to be $9000, while amount of the liabilities and the outstanding capital is the same as it was. Clearly, the $1000 loss sustained during the period must be charged against the capital. A business organization is insolvent if its assets are less than its liabilities; and if, in this case, capital is a liability, the organization is

clearly insolvent. On the other hand, if capital is not a liability, the organization is still solvent, but the capital has been impaired to the amount of $1000. It was decided by the court in a very important New York case that the capital stock of a corporation is not a liability. This is not only good law but sound accounting. The late Colonel Charles E. Sprague, one of the foremost thinkers of his time, stated the matter very clearly in his volume entitled, "The Philosophy of Accounts":

> Thus the right-hand side of the balance sheet is entirely composed of claims against or rights over the left side. "Is it not true," it will be asked, "that the right-hand side is entirely composed of liabilities?" The answer to this is that the rights of others, or the liabilities, differ materially from the rights of the proprietor, in the following respects:
>
> (1) The rights of the proprietor involve dominion over the assets and power to use them as he pleases, even to alienating them; while the creditor cannot interfere with him or them except in extraordinary circumstances.
>
> (2) The right of the creditor is limited to a definite sum which does not shrink when the assets shrink, while that of the proprietor is of an elastic value.
>
> (3) Losses, expenses, and shrinkage fall on the proprietor alone, and profits, revenue and increase of value benefit him alone, not his creditors. For these reasons, the proprietary interests cannot be treated like the liabilities, and the two branches of the right-hand side of the balance sheet require distinctive treatment.

Furthermore, as Colonel Sprague has pointed out in another place, those who consider capital a liability are put in the position of treating insolvency as an asset.

3. *Proprietary accounts of a partnership.*—The

proprietary accounts of a partnership are similar to those of a sole trader, and present no difficulty if we bear in mind that the proprietary interest is subdivided in accordance with the partnership agreement. The accounting records must reflect the intention of the parties as evidenced by their articles of copartnership. There will be for each partner a capital account, a salary account and a drawing account; there will also be the firm's reserve accounts. Interest on partners' capital may be allowed, under the partnership agreement, as a means whereby to equalize capital, and the proper method of treating this in the accounts will be fully discussed in a later chapter of the present volume.

4. *Firm capital.*—The firm capital consists of the amount of money or property that the partners have agreed to contribute to their joint enterprise. Sometimes one or more of the partners will contribute to the enterprise only their skill or labor, and not infrequently these contributions of skill and labor are relatively more valuable than money and property. It is not possible, however, to register in books of account the value of these latent or hidden assets, so that the labor or the skill which such a partner may contribute can be considered as capital only in a restricted sense.

For this reason, when a firm is dissolved a partner who has contributed only skill is not entitled to share in the ultimate distribution of the capital of the firm. Accordingly, when the firm's debts are paid the capital remaining is returned to the other partners in the

proportion in which they contributed it. But the partner who has contributed only ability or skill is still liable for his share of the loss in capital.

It should also be noted that the expression, firm property, is not synonymous with firm capital. The amount of firm capital is specified by the articles of copartnership; it is a fixed sum. But the firm property varies from time to time; it may be greater or less than the firm capital. The firm capital may, however, be increased or decreased, provided the consent of all of the partners is obtained.

5. *Partnership good-will.*—The good-will of a trading firm is an asset in which it is only right that the estate of a deceased partner should share. According to the old common-law doctrine, the good-will of a firm reverted, upon the dissolution of the firm, to the surviving members, but this extremely harsh and unjust rule has now been modified. It is well to provide in the partnership articles for the method to be employed in valuing the good-will of a business upon the death or retirement of a partner.

It seems, however, that in the case of a non-trading partnership, good-will, as a firm asset, is not recognized. The following is the opinion of Judge Storey on the subject:

> It seems that good-will can constitute a part of the partnership effects or interests only in cases of a mere commercial business or trade, and not in cases of professional business, which is almost necessarily connected with personal skill and confidence in the particular partner.

6. *Unincorporated associations and societies.*—Labor unions, societies, clubs and charitable and educational institutions are frequently organized as unincorporated associations. The capital funds of such associations are obtained thru contributions, bequests, legacies, and membership dues. The proprietary interest will be represented by the balance standing to the credit of the dues account, augmented by the surplus of operations of the preceding period carried to the credit of the capital surplus account, and further increased by any balances that there may be in reserve accounts. Organizations of this type frequently receive gifts, which may be restricted or unrestricted. The former will include gifts for special purposes, or permanent funds created by the organization itself. The latter will include gifts made with the stipulation that they be used to meet the current expenses of the organization. The amounts contributed for special uses to organizations of this type are sometimes credited to reserve accounts. The term "reserve" is not appropriately applied to items of this character, because that expression has a special meaning in accounting terminology—it suggests a reservation of profit or surplus. Furthermore, the term, as it is generally used, does not convey the idea of the organization's responsibility in accepting gifts that are given with the understanding that the organization shall use the principal or income for a certain purpose, which is specified.

For example, let us assume that John Smith left by will to the Memorial Hospital the sum of $2,000,000, of which $1,500,000 was to be used for the purpose of erecting a new surgical building to be known as the Smith Memorial Surgery. The will also provided that the balance of the bequest was to be used for the purpose of establishing an endowment. Only the income of this endowment was to be applied to the maintenance of the new building. Upon the acceptance of such a gift, the trustees of the institution would have a duty to preserve intact the principal of the endowment for the building, and to invest the gift in accordance with the provisions of the trust.

The accounts of the institution should at all times reflect the amount of the gift, as well as the disposition which is made of it. It will be noted, also, that the gifts are of a different nature. The larger is for a permanent endowment to be invested in a non-productive asset—non-productive in the sense that it is not to be invested in interest-bearing securities. The smaller gift must be invested in interest-bearing securities; the principal sum must be preserved intact, and only the income from it is to be used for the current purposes of the organization.

Institutions of this character usually have a large number of such endowments, and it is probably inconvenient to carry the detailed record of each endowment in the general ledger of the organization. Instead, a controlling account could be carried in the

general ledger, and to this account should be credited the amounts which are donated to the institution for specific purposes and which are to be invested in fixed and non-productive assets. Supporting this account there should be a subsidiary ledger in which should be recorded the details of each gift, each ledger account containing a full and complete explanation of the terms of the gift. Money or property given to the institution, which is to be invested in income-bearing securities, could be handled in a similar manner; in other words, it should be credited to a controlling account in the general ledger and should be supported by a subsidiary ledger showing the specified conditions attaching to each gift contributed for the purpose of productive endowment.

As the gifts are invested by the trustees from time to time, the amount invested should also be carried in appropriate controlling accounts. There should be one controlling account for the investment of the non-productive endowment, supported by its subsidiary ledger showing the details of the investment; and there should be another controlling account for the investment of the productive endowment, supported by subsidiary records showing the details of the investments.

The following journal entries will illustrate the procedure as regards non-productive endowments, in cases of this kind. Of course, similar entries should be made for the productive endowment, for which the journal entries would be the same; the only difference would be the substitution of the word "productive"

for the word "non-productive." As soon as the institution received the cash from John Smith's executors, the following entry should be made:

Special Cash Funds.........$1,500,000		
To Principal of non-productive endowment ...		$1,500,000

(John Smith Memorial Surgery Endowment)

To record the receipt of this gift under the will of John Smith, which is to be used to erect a new surgical building to be known as the Smith Memorial Surgery.

Special Cash Funds........$ 500,000		
To Principal of productive endowment		$500,000

(John Smith Memorial Surgery Maintenance Endowment)

To record the receipt of this sum under the will of John Smith, which is to be used to create an endowment, the income of which is to be used for the maintenance of the Smith Memorial Surgery Building.

The foregoing journal entry indicates that the cash fund of $1,500,000 has been set apart in a restricted cash account and has been credited to the principal of non-productive endowment. The credits should also be posted in the subsidiary record which is provided for the purpose of showing the detailed amounts that stand to the credit of each of the individual endowments. The amount of $500,000 should be credited to the principal of productive endowment in like manner.

We will assume that the trustees have immediately proceeded to erect the Memorial Surgery and that they have from time to time expended various sums, amounting to a total of $1,200,000. The journal en-

try necessary to record this progress would read as follows:

Investment or non-productive endowment....	$1,200,000
(John Smith Memorial Surgery Building)	
To special cash funds................	$1,200,000
For the cost of the Smith Memorial Surgery Building.	

The "investment of non-productive endowment" account constitutes a controlling account supported by a subsidiary ledger in which will be found the detailed accounts that show the investment of the respective non-productive endowments. It is possible at all times, thru the medium of the controlling account, to tell how much of the non-productive endowment has been invested and how much remains uninvested, since the difference between the total standing at the credit of the principal of non-productive endowment and the total standing at the debit of the investment of non-productive endowment will be the uninvested principal of non-productive endowment. This uninvested principal will be represented by cash in the special cash fund, which is the cash account thru which all trust funds pass. In order to ascertain the details of the various endowments, and the portion of each which has been invested or which remains uninvested, it is necessary only to turn to the subsidiary ledgers.

The first step is to make a list of the principals of the various endowments. This can be compiled from the subsidiary ledger controlled by the principal of the non-productive endowment account in the general ledger. Then in a parallel column, an entry should

be made of the details of the respective investment accounts that are shown in the subsidiary ledger controlled by the general ledger account, "Investment of Non-Productive Endowment." The difference between these two sums should be carried to a third column which should include the uninvested portion of each individual endowment. The total amount shown in the third column will be the uninvested portion of the non-productive endowment. This should be reflected in the special cash fund.

It is to be noted that in certain cases it is not necessary, according to law, to keep the investments of the different productive investments separate. Sometimes it is allowable to provide for the productive investments a consolidated investment account which shall take the place of the individual investment accounts that are a part of the method suggested above. The income from the consolidated investments should be apportioned to the income accounts of the various funds on some equitable basis, usually according to the ratio of the principal of the individual funds to the total invested principal.

In regard to keeping the accounts of a hospital, or other similar institutions, it is also important to note the fact that certain funds are legal trusts and must be invested in securities that are legal investments for trust funds, under the laws of the particular jurisdiction involved.

7. *Joint ventures.*—Because the joint venture is always of short duration, and because its operations are

restricted, it is not generally necessary, in the conduct of such an enterprise, to keep a separate set of books for such ventures. The accounts may be conveniently kept according to the method explained in a later chapter. If, however, it is decided to keep separate accounts, the proprietary accounts may be managed as they would be in the case of a partnership.

8. *Associations and societies.*—The income of an association or a society consists principally of the dues and fees. Against these will be charged the expenses of the association, and the balance that remains in the current dues account at the end of any period will be transferred to an appropriately ear-marked surplus or reserve account. In other cases, the dues account may be transferred to the credit of a revenue-and-expenditure account, and the expenses of the period will be charged against this account. The balance of the revenue-and-expenditure account may be transferred to surplus or to a special reserve account, which should in some way be distinguished from the other accounts. It is better to call the surplus account of an organization that is not conducted for profit, "Capital Surplus," in order to differentiate it from the profit-and-loss surplus of corporations. The surplus of associations is sometimes in part restricted. Life memberships, for example, usually form a part of the restricted surplus, because the money paid in is generally credited to a special account and the income of the funds only is used for the general business of the organization.

9. *Proprietary accounts of stock corporations.*—The capital-stock account in a corporation represents the original contribution of the members. It may be increased or decreased only by means of the method that the law provides. The profits from operation are carried to a surplus or undivided profits account, out of which the distribution of profits, in the form of dividends, is made. If, instead of a profit being made, a loss is sustained, the amount of the loss is charged to a deficit account. When a corporation is organized with a capital stock that has a stated par value, the deficit account cannot be charged against the capital account. In such a case a situation arises which seems to involve a contradiction—that of including a deficit among the assets in a balance sheet. In order that the deficit may in no way be mistaken for an asset, the deficit account should be very carefully marked as such.

10. *Capital stock with no par value.*—The laws of some states permit the organization of a corporation that has capital stock with no par value. In the case of such a concern, certificates are made out which represent fractional shares of the total capital of the organization, but which bear no statement as to the par value of these shares. Thus, if A pays into the company $1000 and receives in exchange 12 shares of stock out of a total issue of 1000 shares, his certificate will state that he has a $^{12}/_{1000}$ share of the capital of the company. Any assets acquired by the concern will be placed upon the ledger at the value

decided upon by the board of directors, and the capital account will be credited with this value. The stock-certificate book and the stock ledger will reveal the number of shares issued in exchange for the assets.

If this method of operating the capital account is used, assuming that the organization has not begun operations, the capital account represents the total of the contributions made by the members, and the book value of the stock will be the par value of the shares. This book value may be found by dividing the amount standing to the credit of the capital account by the number of shares issued and outstanding. There is no necessity for maintaining a surplus or an undivided profits account, since the surplus from current operations will be transferred directly to the credit of the capital account. In a like manner a deficit from operations will be debited to the capital account.

If it is desired, a surplus account or a deficit account may be carried by means of the same method as is customary when capital stock has a fixed par value, but this is unnecessary. The only advantage would be that in this way the average book value of the shares at the time of organization could be shown.

Under either form of organization any portion of the free surplus set aside in specific reserves, such as sinking fund reserve, reserve for the redemption of debt, or reserve for renewals and betterments, should be stated separately.

11. *Proprietary accounts of non-stock corporations.*

—A non-stock corporation, as the name implies, does not keep accounts for dividends, profit-and-loss surplus or capital stock. Otherwise, the accounts of this kind of corporation are the same as those of associations and societies.

12. *Reserves as a part of proprietorship.*—Reserves are generally divided into two broad classes—those which represent losses actually sustained in the value of assets or anticipated losses; and those which are a portion of the surplus, and which are created by charges to operating expenses or surplus. A third class is sometimes included—reserve for taxes, etc.; but such accounts are really liabilities.

Good examples of the first class of reserve accounts are the reserve for bad debts and the reserve for depreciation. Theoretically at least, these reserve accounts are created to offset a decline in the value of the relevant assets, and they are increased as rapidly as the assets which they offset shrink in value. But this may not always be the case. Reserves for depreciation and reserves for doubtful debts are sometimes created for greater amounts than are necessary to take care of the losses sustained. Where, however, the reserves are created to measure actual losses, they cannot be proprietary accounts and should not be considered as part of the net wealth. Thus, if a reserve for depreciation has been created to take care of the accrued depreciation to date, it represents that portion of the asset value which has disappeared. It cannot, therefore, be said to be a portion of the proprietorship,

because a certain amount of the original capital, corresponding to the amount of the reserve, has been consumed in operating. On the other hand, those reserves which are not created for the purpose of measuring losses actually sustained, but which represent funds set aside out of surplus and locked up so effectually as to prevent their distribution as dividends, are part of the proprietary interest.

13. *Capital in the economic sense distinguished from capital in the accounting sense.*—In the volume on "Economics" in the Modern Business Text the reader learned that capital, in terms of economics, is a fund or stock of wealth which is used in the production of other wealth. The economist regards capital only from this point of view; capital to him means assets. From the accountant's standpoint, the term capital means proprietorship, or ownership—in other words, the equity in the assets. Altho the terms are often used interchangeably in legal decisions, it is important to bear this distinction in mind in reading business literature. Because of the liability of confusion in the terminology, the word proprietorship is coming more into use. If a business had no liabilities the economist's conception of capital would agree with that of the accountant, but since such a situation seldom occurs, it is well to keep clearly in mind the different meanings of this term.

REVIEW

In what respects are the proprietary accounts of a partnership different from those of a corporation?

Could you outline a system of accounts for a charitable organization, whereby it would be enabled to control its investments and endowments properly?

What class of reserves do not constitute a part of the proprietorship?

What are the proprietary accounts of a corporation? Of a non-stock corporation?

CHAPTER II

REPAIRS, RENEWALS, DEPRECIATION AND FLUCTUATION

1. *Difficulty of distinguishing between capital and revenue charges.*—Whether a certain item of expenditure should be charged to capital or to revenue account is a perplexing question for both accountants and business managers. It is also a question for which it is easy to prescribe general rules but difficult to provide for their practical application. The importance of this distinction may best be shown by two hypothetical cases.

2. *Intentional confusion of capital and revenue items.*—In the first case, a corporation has an issue of income bonds bearing interest. Now if the board of directors should charge improvements which materially increase the earning capacity of the corporation against earnings, instead of to capital account, there may be nothing left for the holders of the income bonds. As this interest is payable only when there are earnings, one can readily see the difference which such a charge makes.

The peculiar feature of income bonds, as shown in the Text on "Corporation Finance," is that the interest is not a fixed charge as in the case of mortgage bonds, but only a lien against the income of the cor-

poration. Moreover, the holder of income bonds receives interest only where there are earnings left after all fixed charges have been defrayed.

3. *Surplus produced by wrong classification.*—In the second case the situation is reversed. A corporation has made repairs and improvements which do not increase the earning capacity of the company but which are actual replacements of assets which were wasted during operation. The board of directors are in a quandary. On account of business depression they fear they will be unable to declare the usual yearly dividend. But if they withhold the dividend, serious fluctuations in the stock of the company may be noted in the market quotations. To guard against such a contingency, the directors order the repairs and improvements charged to capital and treat them as acquisitions of property and hence assets, leaving to the corporation a surplus which may be used for the payment of dividends.

It is not intended here to discuss the propriety or impropriety of the action of the directors in either case, but merely to cite these illustrations that the reader may understand the importance of proper classification of capital and revenue items.

4. *Definition of terms.*—"Capital receipts" represent sums contributed to a business with the intention of using them to carry on the enterprise.

"Capital expenditures" is a term given to expenditures incurred for the purpose of acquiring, extending or completing the equipment of an enterprise in order

to place it on a revenue earning basis, or to increase its earning capacity.

"Revenue receipts" are the receipts of business operations, i.e., earnings. The cash revenue receipts will generally be less than the actual earnings, as practically no line of business is conducted on a strictly cash basis and, therefore, the credit to revenue account, and not the receipts in cash, will show the true earnings for the period.

"Revenue expenditures" are those expenditures which are incurred in the operation of the business. Indeed, any expenditure of a business that does not improve the fixed assets, increase the earnings, enlarge the field of operations, reduce the cost of doing business, or any expenditure the life of which does not extend beyond one year, should be charged to revenue.

"Additions" are amounts which are expended for additional buildings or equipment or facilities; in brief, those expenditures made for structures or equipment which do not take the place of anything previously existing.

"Betterments" may be distinguished from additions in that they include the improvement or enlargement of buildings, machinery or equipment already in existence.

"Replacements" is the term used to designate the removal of a capital asset which has become exhausted or inadequate in service and the substitution of another of the same or greater capacity. Where the new unit has a capacity substantially greater than that

for which it was substituted, it is proper to charge the cost of replacement to capital account. The unit displaced should be credited to capital account.

"Renewals" include the cost of extending the life period of some capital asset already existing thru a process of extensive repairs; renewals may generally be termed extraordinary repairs. Minor renewals are generally included under the heading "repairs."

The term "repairs" embraces expenses incurred in replacing any part of a unit the replacing of which is made necessary thru wear and tear or thru accident. Repairs are distinguished from replacements in that replacements are charged to the capital account and the value of the article displaced is credited to that account. Repairs are strictly revenue items and are not to be charged to the capital account, but should be charged to operating expenses for the reason that the replacement or renewal is a minor one and does not cause a substantial change of identity in the unit of equipment upon which the expenditure has been made.

5. *Capitalization of additional equipment.*—There is usually little difficulty in determining whether charges for additional equipment should be capitalized or not. However, problems sometimes arise in the case of the purchase of the entire assets of another organization. Let us assume that company "A" purchases the assets of company "B" at a flat price and that before purchasing these assets company "A" has carefully considered the value of each of them and

has determined the purchase price accordingly. It may happen that with the equipment are certain units of no use to company "A" but which the company is obliged to buy in order to secure the remainder of the equipment. It would be proper for company "A" to value the assets acquired at the purchase price, treating the undesirable units as scrap material. If, on the other hand, a mistake was made in the first valuation of the assets, and upon revaluation it is discovered that the equipment purchased will require considerable expense to prepare it for operation, it is evident that the capital account should be charged with only the cost price of the units acquired. The loss due to the mistake in valuation becomes a proper charge against surplus account, because it is not allowable to capitalize mistakes in judgment. However, if it was known at the time of purchase that these amounts would have to be expended, the situation would be different and the expenditures on the purchased equipment would then become capital charges. The repairs which company "A" must make on any equipment purchased in this manner may therefore be capital or revenue expenditure depending upon the conditions under which the units were purchased.

Occasionally, in reorganizations of manufacturing and trading concerns a new manager takes over a much neglected plant. The old management has failed to provide properly for depreciation and has indulged in the pernicious economy of neglecting the necessary repairs and renewals which should have been

made on the equipment. The new management might very properly object to charging in the revenue account the cost of repairs and renewals on wornout equipment, and it might claim also that such repairs should be capitalized and not charged against the revenue account. This procedure would, of course, be improper and would result in a false profit being shown, but inasmuch as the expenditures should have been made by the previous management, the amount necessary to bring the equipment into proper operating condition should be charged to surplus account. If there is no surplus account against which the items can be charged, the expense of making repairs can be carried as a deferred charge in an appropriately earmarked account on the balance sheet and be written against surplus in succeeding years.

6. *Adjustment of inventory valuations on change of management.*—While not directly connected with the property account, it may be noted in this connection that the new management may also object to the inventory valuation of merchandise carried on the books by the former management. It frequently happens that the old management in order to make a good showing may have appreciated the inventory, or it may have carried at inflated values merchandise that is shopworn, out of fashion or not in proper condition to sell. If these conditions obtain and the merchandise is overvalued, the adjustment in the accounts should be made thru surplus at the beginning of the period and not thru the current revenue ac-

count. It is only fair to the new management to see that at the commencement of its operations all equipment shall be in good operating condition and the merchandise inventory properly valued.

7. *When shrinkage in the value of capital assets is to be ignored.*—Capital assets, however, may decrease in value without affecting revenue. For example, a shrinkage in the value of assets may occur owing to causes outside of the ordinary operations of the business. Therefore, as long as these assets are not disposed of, such shrinkage can only be an estimated item and may properly be ignored in the accounts.

8. *Capital expenditures are extended or acquired assets.*—Most of the errors in principle that occur in practical work show a lack of effort to discriminate strictly between capital and revenue items. One needs to bear in mind in this connection that all expenditures recorded as capital expenditures must be represented by actual assets. Nothing remains to represent expenditures that have been incurred upon revenue account. Has the particular expenditure, in any individual case, been incurred for the sake of improving the earning capacity of the enterprise? If so, it is a charge against capital and should be classed as one. If, however, the result of the expenditure has been merely to put the earning capacity of the undertaking on the same footing as before a decline—such decline being due to ordinary wear and tear—then it must be charged against revenue. Not mere renewals but

only the extension or acquisition of new assets can be recorded as capital expenditures. If an asset for which an expenditure was made exists at the end of the current period as an asset, such expenditure should be charged to capital. On the other hand, if the asset is consumed during the current earning period, it must then be charged against the revenue of that period.

We frequently have examples of expenditures that may or may not result in a direct increase in the earnings of an organization; thus where a railway company tears down an old station and replaces it with a larger, more commodious and more modern structure, considerable doubt exists as to whether such expenditure could be properly capitalized. It is granted that the earnings will not increase; nevertheless the existing structure was inadequate, and undoubtedly the building of the new station will result in a continuance of public favor and patronage. In such a case it is considered proper to capitalize the new structure and displace the cost of the old station from the asset accounts.

9. *Accounting practice in the case of replacements.*—From the definition which has been given for replacement, it is evident that the term conveys the idea that one article is substituted for another of the same or greater value or capacity as distinguished from a renewal which renews some existing article by manufacture or extensive repair. Some accountants, however, claim that inasmuch as variations in cost are to be expected, therefore only bona fide investments

should be capitalized. To illustrate: If assets which originally cost $200,000 were to cost in renewals $250,000, the whole cost of such renewals would be a revenue charge. If, however, the assets which ordinarily cost $200,000 were replaced by assets of a higher revenue earning capacity, due to the superior quality of the materials used for the making of such assets, the method of apportioning would be as follows: ascertain what the exact cost of replacing the existing asset would have been and then charge only that sum to revenue and capitalize the excess.

Many accountants follow the policy of considering the "last cost" as a capital charge. If assets which originally cost $10,000 are replaced at a cost of $12,000, the excess is charged against capital. In other words, they claim that the last cost is the only correct basis because each concern will replace its plant at the least possible expense to itself.

10. *Objection to capitalization on basis of last cost.*—The latter plan appeals to the writer as a most desirable and fair method to be followed in all cases, because under this practice the plant always appears in the accounts at the last cost, that is, the cost of the plant as it stands at the present time. Therefore, the reconstruction cost would be charged to capital and the cost of the construction or equipment formerly on the books would be displaced.

The principle is of importance in the case of public utilities where the question is involved of determining a rate which is fair to the consumer and yet will yield

to the utility a reasonable rate of return on its investment. It is urged that it is only fair to the utility that the investment in plant shall appear at the present cost of the plant and not at that of some earlier date when perhaps material and labor charges were much less. Opinions differ in this matter but it is worthy of note that most of the commissions charged with the duty of regulating public utility companies favor a provision for the payment of extraordinary replacements out of earnings.

In the volume on "Corporation Finance," the reader has seen that prior to the declaration of dividends, the board of directors of a conservatively managed corporation will set aside a reserve for the replacements of an extraordinary nature that are not fairly chargeable against the revenue of the year in which they may be made. Thus, a railroad which was by law compelled to abolish grade crossings on its right of way, might find it more economical to build a new right of way instead of attempting to abolish the present grade crossings. Under the ruling of some of the regulatory commissions, the new right of way would be a proper charge to capital and the cost of the old right of way should be credited to the property account and charged to an abandoned property account to be written away over a series of years. Pending its final elimination from the balance sheet it would be carried as a deferred charge to future operations. If a reserve for such contingencies had been provided, the cost of the abandoned property

would be charged to that account. If the ledger did not disclose the cost of the abandoned property, the estimated replacement cost would be the amount used in the credit to property account and the charge would be made to abandoned property account.

11. *Who should pay for the cost of progress?*—The evils attending overcapitalization are much greater than those attending undercapitalization. When a railway company builds a new station and capitalizes the cost, we have an example of the cost of progress. Many public service corporations are compelled to pay annually large sums for the improvement of facilities which may not cause a direct increase in revenue or at least may only realize the increase after a series of years. If good material and efficient working equipment are scrapped and better operating equipment or more improved inventions substituted, should not these be considered as a part of the cost of progress? Should not this tendency be encouraged? Is it fair to compel the stockholders to pay for the entire cost of industrial progress thru the practice of charging all such expenditures to earnings? Possibly a solution to the problem will be found in keeping two sets of records; one on the basis of original cost, under which all increased costs of replacements will be charged to revenue or surplus; the other on the basis of "last costs" which basis will be used in determining a fair rate of return.

12. *Extraordinary reconstruction costs where reserve for depreciation is inadequate.*—The situation

referred to in the preceding paragraph must be distinguished from that in which failure to provide adequate provision for depreciation in prior years results in extraordinary expenditures for reconstruction. In this case, the failure to provide properly for the declining value in fixed assets, due to realization of their service-units, has resulted in stockholders receiving profits that were not earned. When conditions require large expenditures for the purpose of restoring capital facilities, these costs should be assessed against the surplus; and if no surplus exists, and the amount of the expenditures is so great as to make it unfair to charge the cost against the profits of one year, the amount must be clearly shown in the balance sheet in a properly ear-marked suspense account.

Moreover, in practice, the new equipment substituted is frequently more valuable and capable of rendering more efficient service than the old. The replacement charge is then made up of three elements; first, a part which represents the increased value of the equipment or its greater service-rendering capacity; second, a part which represents deferred maintenance charges, and third, a part which represents the current depreciation applicable to the period in which the replacement is made. The first is a proper charge to capital account; the second is chargeable to the surplus account or if there is no surplus account, to a suspense account properly ear-marked; the last should be charged to the current income account.

The suspense account, in the last event, represents an impairment of capital and this condition should be remedied before any dividends are paid.

13. *Danger involved in giving revenue the benefit of doubtful expenditures.*—It must be admitted that there is great danger in capitalizing charges for betterments which do not increase earnings nor decrease operating expenses. Some accountants favor giving revenue the benefit of all doubtful expenditures and increasing capital by the amount of those expenditures and adding a corresponding increase to the amount of profits for the period. This practice invites two dangers; first, that a dividend might be declared out of a fictitious surplus which might render the board of directors personally liable, and second that the organization itself may be seriously handicapped by a lack of capital thru improper dividend disbursements, and might eventually have to retire from business. The board of directors might protect itself from these dangers by setting aside a portion of the surplus to prevent the payment of unearned dividends where it is deemed best to capitalize such doubtful charges.

It should not, of course, be lost sight of, that where items are charged to capital that should have been charged to revenue, the matter is equalized over a period of years because the increased amount in the capital account makes necessary a larger provision for depreciation. This is charged against income with the result that when items are erroneously capi-

talized or carried in a suspense account for a series of years as abandoned property, the ultimate effect is to load the income account in the succeeding years with these amounts. The procedure results in charging future earnings with amounts which should have been charged against surplus created out of past earnings. The outcome of this practice is that the stockholders of the future are robbed for the benefit of those of the present. The Federal Income Tax law, which permits a deduction from income for depreciation, has brought the advisability of providing for depreciation more keenly to the attention of operating managers. The result is that many who formerly opposed depreciation allowances or provisions for renewal and contingency reserves now favor the more conservative practice.

14. *Gauging repair and renewal expenditures by profits made.*—Many business executives claim that the depreciation factor is negligible in their respective businesses because thru liberal allowances for repairs and renewals they endeavor constantly to keep the organization up to one hundred per cent efficiency. On this basis they claim that the equipment is always as good as new.

The argument is sometimes used that increases in the value of the intangible properties of railways is greater than the depreciation of physical properties and that for this reason no depreciation or renewal reserve need be provided.

Other executives provide large amounts for depre-

ciation in prosperous years and set aside either small amounts or nothing in lean years, with the result that the true earnings of the individual years are not stated in their respective income accounts. While in practice this haphazard method in many cases may not result in the overstatement of property values the procedure cannot be recommended. Pernicious economy in the expenditures for repairs often increases the depreciation of machines so that the ultimate cost of the repairs and renewals is greater than if the necessary disbursements had been made at the proper time.

15. *Repairs and renewals.*—During the early years of the life of a new machine the charges for repairs and renewals will be slight, tending to increase as the machine grows older. When a plant has been operating for some length of time, the constant addition of new machinery has a tendency to average, from year to year, the charges for repairs and renewals. In other plants, the item is a fluctuating one. It would seem desirable in some cases to attempt to predetermine the cost of the repairs and the renewals during the life of the machine, and to make a periodical charge against income and a credit to a reserve for repairs and renewals for the annual pro rata amount. The actual cost of the repairs and the renewals made on a machine over the first few years of its operation would probably not amount to the sum set aside with the result that there would be a credit balance in the reserve for repairs and renewals account; later, as the cost of repairs and renewals increased and exceeded the an-

nual sum charged to income and credited to the reserve account, the excess credit balance in the reserve account would be consumed gradually. Under this method of procedure a repairs and renewals account would receive the charges for the actual cost of the repairs and the renewals made during the period. The income account would be charged with the predetermined amount based upon the estimated cost of repairs made during the life of the machine and this amount would be credited to the reserve account; the amount charged against income would appear in the profit-and-loss account; the amount charged to the repairs account, which represents the actual cost of the repairs made during the period, would be transferred at the closing of the books to the debit of the reserve for repairs and renewals account. If the amount of repairs was underestimated at the beginning, the undertaking in the succeeding years would, naturally, be under the necessity of increasing the amount to be charged against income.

This operation does not of course take care of the depreciation which goes on irresistibly even tho proper amounts are expended for repairs. While depreciation has been discussed both in the volume on "Accounting Principles" and in the volume on "Cost Finding" it may be well to state here that the question of the depreciation charge, for such depreciation as accrues irrespective of operations, is one that creates considerable discussion. Some accountants state that depreciation should not be considered a charge against

operations, if it goes on irrespective of operations. It is also pointed out that, during enforced idleness, certain equipment might depreciate much more than if properly cared for during a longer term of actual operation. The difficulty, perhaps, may best be adjusted by charging depreciation against cost of operation while the factory is in operation, since machinery is purchased with the view of wearing it out as it is operated. If, however, due to enforced idleness, there is no production and consequently no units of production against which the depreciation may be charged, this charge may well be made against the profit-and-loss surplus accounts, but it cannot be ignored. The excessive undistributed overhead accumulated during a period of dull business, if charged against the production of the following period, improperly inflates costs and also results in erroneous inventory valuations.

16. *Replacement fund.*—In order that the needed capital may be on hand when it is necessary to provide for replacements, a fund may be provided by setting aside out of cash an amount equivalent to the annual charge for depreciation. If this fund is invested in safe interest-bearing securities the necessary cash will be provided from which to purchase new equipment without the need of additional financing or without crippling the working capital of the business. The objection to this plan is that the business can earn very much more profit from the employment of capital in production, than it can in in-

terest from money invested in this manner; furthermore, as the replacements will probably be made gradually, they can be provided for from the general cash funds of the business without interfering with the business in any way. The replacement fund or depreciation fund is very seldom found in ordinary manufacturing organizations.

17. *The advantages of a plant ledger.*—Much of the difficulty that surrounds this general question will be dissipated if the organization maintains a plant or equipment ledger wherein each article or unit of equipment is given a separate account in which is shown the original cost, the cost of annual repairs and renewals, the amount of depreciation provided annually, and the residual or book value at the end of each year. In large undertakings the use of such a ledger is almost an absolute necessity if anything resembling accuracy is desired in the plant account. As an illustration of the difficulties that are encountered in handling the property accounts on the books and in arriving at the approximate life of machinery, the following case which came within the experience of the writer, may prove of interest: A manufacturing corporation desiring to instal a new stationary engine, removed the one in use and set up another in its place; the old engine was shipped to a subsidiary company having a smaller capacity than the parent company, and was charged to the subsidiary company at its book value on the books of the parent company. The engine continued to give good service for

a number of years and only ordinary repairs and renewals were necessary. Owing to a flaw which had remained undetected for a number of years, the crank shaft broke and the plant manager, giving the engine number, wired the engine builders for a new shaft. The manager found to his dismay that the engine builders had destroyed all patterns of this type of engine because of their belief that such an old style was no longer in existence. This being the case, it was necessary for the builders to send machinics to the plant in order to get the measurements necessary to make a new crank shaft.

18. *Moving and altering a plant.*—It may be necessary to move a plant or to rearrange the machinery within it. Undoubtedly this expense would not be undertaken by a business concern unless it was felt that a saving thru operating efficiency, or other economies in management would result. This raises the question as to whether or not such expense is properly capitalized. It is probably inexpedient to capitalize such expense but a better plan is to charge it off against the revenue account in the year in which the expense was incurred. If, however, it is felt by the management that a distinct benefit will be realized, it may be proper to spread the expense over several years, carrying it in the balance sheet as a deferred charge to future operations. This would be the advisable course if the expense were considerable and if it were reasonably certain that economies in management expense would result from the change.

19. *Improvements made upon leased property.*—In connection with improvements made upon leased property and permanent machinery and fixtures purchased, the provisions of the lease must always be given consideration. If the lease provides that the machinery and equipment cannot be removed at the expiration of the lease, it is evident that the life of the asset is coterminous with the life of the lease, and that the value thereof must be written away against profits during the number of years that the lease has to run.

20. *Transfers of equipment from one station unit to another.*—In the electric light industry the question of the transfers of equipment from one station unit to another frequently raises interesting questions; thus, if a certain type of generator becomes inadequate and it is considered desirable to instal a larger type and remove the old generator to a new station where it will adequately serve the purpose, the question will be raised as to what value should be used in charging the old generator to the new station unit. It is urged by some that the book value should be taken; others hold that the market value of the equipment should be employed. The market value of second-hand electrical equipment is very low and usually under its actual value. Furthermore, no one can tell the market value of the equipment because it has not been offered for sale. It would seem better to transfer such equipment at its book value provided that proper depreciation charges have been made during

prior years based upon the estimated operating life of the equipment. The expense of the second installation should not, however, be capitalized.

21. *Separation of depreciation and renewal reserves.*—It will be readily granted by most accountants that the question of repairs and renewals and the question of depreciation must be treated separately. For that reason it would seem desirable to create two reserves; one a reserve for depreciation and the other a reserve for renewals. The advantage of this method is that neither of the reserves can be exhausted without attention being called directly to the fact, whereas if the reserve for repairs and renewals is merged in the reserve for depreciation, the fact might be overlooked. It follows, then, that if the amount set aside for renewals and for depreciation of each separate unit is kept track of in the plant ledger, the information will prove of value in the subsequent treatment in the accounts of the individual units of plant equipment; moreover, by this means it is possible to compare the actual expense of the repairs of separate units with the amounts set aside on the predetermined basis for repairs and renewals. It is obvious that nothing should be charged against the reserve for depreciation on account of repairs and renewals.

22. *Capitalization of machinery made for its own use by a concern.*—Where a firm manufactures machinery for its own use, the capital account should be charged with the cost of the material, the direct labor

and that proportion of manufacturing overhead applicable to the machine, and the latter accounts credited therewith. It would be incorrect for the firm to add any element of profit to the capitalized value because such procedure would inflate the assets by the amount of the profit. Nor should the amount be credited to sales account since it would inflate the sales account by a corresponding amount.

A profit must not be confused with a saving. No profit is realized nor is a sale effected, until goods are transferred to outsiders at an excess over cost. If a concern is able to manufacture the machine more cheaply than it can buy it in the open market, of course a saving has been made. Here the question will arise as to whether or not it would be proper to capitalize the machine at the market value. The answer is that capital accounts should not be charged with anything except the cost of acquiring the asset. If the concern can manufacture the machine for less than it can purchase it in the open market, it has clearly made a saving to the extent of the difference. On the other hand, if the concern has made a miscalculation and the cost of the finished machines proved greater than their prevailing market price, the concern would not be justified in capitalizing the machine at the cost price because to do so would be to capitalize a mistake in judgment. The market price of the machine should, in that event, be used as the basis for the charge to capital account and the difference between the actual cost and the

market price would be charged to surplus account.

23. *Conclusion.*—The foregoing discussion is not intended to be exhaustive and the conclusions stated are subject to adjustment, due to change in surrounding conditions and circumstances. It requires much discrimination and experience to determine whether specific expenditures belong to capital or to revenue. Probably no other question offers greater difficulties to the accountant as well as to the operating manager than this question of capital and revenue charges. If those who are charged with the duty of making a decision act with common honesty and good judgment the difficulties are not insurmountable. In cases where plant records have been inadequately kept for a series of years, where depreciation has not been properly considered, or where the proper discrimination has not been employed in distinguishing between capital and revenue charges, it is undoubtedly a wise plan to have the physical assets appraised by competent valuers for the purpose of arriving at their true value. Once this value has been arrived at, the necessary detail plant ledger records can be installed and the accounts in the future will reflect the true financial condition of the enterprise.

REVIEW

How would you differentiate between capital receipts and revenue receipts? Between capital expenditures and revenue expenditures?

What effect should fluctuation in value, owing to economic conditions, have upon the capital assets?

If a steamship company builds a larger and more commodious

dock in place of one now in use, at a greater cost, would you capitalize the cost of the new dock?

What is the significance of the term replacement and how should replacements be treated in the accounts?

Do you approve of the practice which some corporations adopt of using a repairs leveler by charging a stated annual sum against income for repairs and renewals and adjusting the actual cost of repairs and renewals thru the medium of a reserve account created at the time the level annual charge is made?

The manager of a public utility claims that depreciation in rolling equipment should not be provided for because the annual expense for repairs more than covers depreciation sustained; moreover he urges that the increase in the value of the franchise more than covers any capital loss otherwise sustained; do you agree and if so, why, and if not, why not?

In your opinion, would it be wise to establish a replacement fund?

What are the advantages of a plant ledger?

What considerations affect the life of improvements upon leasehold property?

CHAPTER III

PARTNERSHIP PROBLEMS AT ORGANIZATION

1. *The importance of properly drawn articles of copartnership.*—The partnership relation is a fruitful source of litigation. Many of the disputes that arise between the members of a firm might, however, be avoided if the articles of copartnership included certain clauses dealing with the accounts. In an article on this subject which appeared in the *Journal of Accountancy,* Mr. Leo Greendlinger, C. P. A., recommended that the partnership agreement contain the following accounting clauses:

(a) That proper books of entry be kept.

(b) That the entries be made by each partner.

(c) That the books and partnership documents be kept at the place of business and be open for inspection of all the partners.

(d) That the books be kept under the direction of the acting partner.

(e) That all checks, drafts, acceptances, etc., be signed by the acting partner, except in the case of his sickness or absence.

(f) That all drafts, acceptances, or securities be made or taken in the name of the firm.

(g) That real estate purchased be bought by the acting partner in trust for the firm.

(h) That . . . Bank be used by the firm.

(i) That the cash book be made up . . . (state time—monthly, quarterly, etc.).

(j) That the cash collected be deposited daily.

(k) That all moneys received by each partner be duly paid in.

(l) That a general accounting be made yearly or half-yearly.

(m) That the inventory and the balance sheet be signed by each partner and be conclusive.

(n) The ledger, among other accounts, shall contain:

(1) An account for each partner's partnership obligation, which shall be debited with the amount the partner obligates himself to put in the business, and credited with what he actually puts in.

(2) A drawing account for each partner, to keep separately his withdrawals.

(3) If there be advances made by any partner to the firm as a temporary loan, an account should be kept under the title, "A.B.'s Loan to Firm Account."

(4) Before a division of profits be declared, the profit-and-loss account shall be debited with depreciation at a fair rate on the fixed capital subject to depreciation, and depreciation account shall be credited with same. The depreciation account shall in the balance sheet be always treated as an offset to the fixed capital, subject to depreciation.

(5) There shall also be two reserve accounts—one, the reserve account for doubtful debts, and the other, the general reserve account. The former shall be credited with . . . % of the debts due the firm and remaining unpaid at the time of closing up the accounts, as a contingent fund to meet bad debts; and the latter, the general reserve account, shall be credited with . . . % of the balance remaining in the profit-and-loss account, and the profit-and-loss account debited.

(6) Extraordinary profits and losses, i.e., such as do not usually occur, but are accidental, shall, as they arise, be carried to the general reserve account. The remaining profit and loss shall now be duly divided and carried into each partner's drawing account (credit side). The drawing ac-

count to be then closed and the balance carried to each partner's capital account.

2. *Other important provisions.*—In addition, the author would recommend that the articles state whether or not interest is to be allowed on capital contributed by all the partners, or only on the deficit or excess capital contributions, or whether any interest at all is to be allowed on capital. If interest is to be charged on withdrawals, a clause to that effect must appear in the partnership agreement. Since the death of a partner works a dissolution of the firm, the partnership agreement should provide against the abrupt termination of the business at a time when dissolution on account of death would result in unusual loss. If, for example, a member of a firm of silk merchants should die in the middle of a season, the consequent dissolution of the firm might work a serious loss to all the partners. This contingency is usually provided for by inserting in the articles of copartnership a provision to the effect that if death occurs it shall be considered to have occurred at the end of the season or at the end of the current fiscal period. The method to be employed in valuing the good-will of a business at the death or retirement of a member of a firm ought to be stated. The profit-and-loss-sharing ratio should invariably appear.

3. *Difference between the accounts of a business controlled by a sole proprietor and those of a partnership.*—With the exception of the opening entries and the closing entries at the end of a fiscal period, the

accounting principles are the same for a business under a sole proprietor as for a partnership. It is necessary to show the subdivisions of the proprietorship at the beginning, in order that each partner's equity in the net assets may be properly stated. The division of the net profits at the end of the fiscal period will be governed by the articles, and the capital accounts at the end of each period will reflect the status of the individual members of the firm. There may be further differences in the accounts of the individual partners, such as, for example, a difference in the salary paid, dependent, perhaps, upon whether or not a partner gives his entire time to the business; and also differences which arise from the fact that one partner may have contributed more capital than the other partner to the venture, or may have loaned money to the business. Therefore, before the final distribution of net profits is made to the partners, adjustments are often necessary in consideration of differences in capital investment, amount of time devoted to the business and the skill or ability of the individual partners.

4. *Opening entry for partnership books.*—Following the suggestion contained in the article of Mr. Greendlinger quoted above, the books of the partnership should be opened by an entry which will charge each partner's personal account for the amount which he has agreed to contribute, at the same time crediting his capital account therewith. Thus, if A and B, in forming a partnership, agree to contribute

respectively, $100,000 and $80,000, the opening entry would be framed in the following manner:

A (Personal Account).............$100,000
B (Personal Account)............ 80,000
  To A, Capital Account................ $100,000
    B, Capital Account................. 80,000
To charge each partner for the amount of his agreed contribution and to credit the respective partner's capital account therewith.

5. *Subsequent entries.*—Each partner should then be credited with the sum total of the assets which he puts into the business, and the individual asset accounts on the books of the partnership debited therewith. If we assume that A contributed sundry assets valued at $80,000 and that B paid in $80,000 in cash the following entry would be made:

Sundry Assets (itemized)...........$80,000
  To A (Personal Account)................ $80,000
To credit the latter for the assets turned over by him in part payment of his capital contribution.
Cash $80,000
  To B (Personal Account)................ $80,000
For cash paid in by him, being full payment of his capital contribution.

The effect of this procedure would be to place upon the books an account which will reflect the deficiency in the capital contribution of any of the partners. A's personal account reveals the fact that he has failed to put in the agreed amount and in justice to his partner he should be charged with interest on the deficit. The assets contributed by the individual

members become, of course, the property of the firm, and it is therefore important that a definite value be assigned at once to any assets other than cash contributed by a partner, and that the agreed value be reflected in the opening entry. The reason for this is, that any increase or decrease in value subsequent to the date of acquirement by the firm, will benefit the partners or be charged to their accounts, in the ratio in which they are sharing profits and losses. Thus, if one of the partners brought in certain securities to the firm as a part of his capital contribution which, on the date of the formation of the partnership had a value of $2,000 and, if the value of the securities should rise subsequently and the firm should sell them for the sum of $4,000, the profit amounting to $2,000 would be distributed among the partners in the ratio in which they had agreed to share profits and losses.

6. *Division of profits and share in the partnership distinguished.*—The purchase of an interest in the profits must be distinguished from the purchase of a share in the business. No confusion will arise if correct principles are followed. To illustrate, X is the owner of a business and sells to Y, a one-half interest in the business for $5,000, on the basis of the following balance sheet:

Balance Sheet of X

Assets	$6,000.00	X, Capital	$6,000.00

It is clear that X is disposing of his asset, good-will, in addition to the tangible assets which the business possesses. If we introduce the value of X's good-will in the balance sheet, the result is expressed in the following statement:

Balance Sheet of X

Assets	$6,000.00	X, Capital	$10,000.00
Good-will	4,000.00		
	$10,000.00		$10,000.00

Since Y is buying one-half of X's interest, his payment for that interest will be a private matter between X and Y and will not be reflected in the books of the new firm. The entry to be made on the books of X will be a debit to the capital account of X and a credit to the capital account of Y to the amount of $5,000. The opening balance sheet of the new firm would then be as follows:

Balance Sheet of X & Y

Assets	$6,000.00	X, Capital	$5,000.00
Good-will	4,000.00	Y, Capital	5,000.00
	$10,000.00		$10,000.00

If it was desired to eliminate the asset, good-will, the balance sheet of the new firm would appear as follows:

BALANCE SHEET OF X & Y

Assets	$6,000.00	X, Capital	$3,000.00
		Y, Capital	3,000.00
	$6,000.00		$6,000.00

The result would be the same if Y had paid X personally the sum of $5,000 and an adjustment made in the books of X by crediting Y and debiting X with $3,000, the excess of $2,000 representing Y's payment for his share of the good-will of the business.

The case would be different if Y came into the business with a one-half interest on the payment of $10,000. Under these circumstances, the opening balance sheet of the firm of X and Y would appear as follows:

BALANCE SHEET OF X & Y

Assets	$ 6,000.00	X, Capital	$10,000.00
Good-will	4,000.00	Y, Capital	10,000.00
Cash	10,000.00		
	$20,000.00		$20,000.00

If the good-will is written off, the balance sheet would reveal the following condition:

BALANCE SHEET OF X & Y

Assets	$ 6,000.00	X, Capital	$ 8,000.00
Cash	10,000.00	Y, Capital	8,000.00
	$16,000.00		$16,000.00

7. *Illustration of purchase of an interest in the profits.*—Let us assume that the agreement in the first case provided that X would admit Y and give him one-half of the profits, upon the payment of $10,-000. When Y had made his payment the opening balance sheet would reveal the following condition:

BALANCE SHEET OF X & Y

Assets	$ 6,000.00	X, Capital	$ 6,000.00
Cash	10,000.00	Y, Capital	10,000.00
	$16,000.00		$16,000.00

It should be noted that in this case the agreement stipulated that the profits and losses are to be shared equally, altho the capital ratios are unequal. This is not an uncommon situation in actual business relations.

8. *Other illustrations.*—Another variation may be illustrated if it is assumed that Y is admitted to a two-thirds interest in the business on the payment of $6,000. Here it is evident that Y is bringing into the business, good-will and business connections in addition to the cash which he contributes, which will make his capital account twice that of X. Under these conditions the balance sheet of the new firm may be represented as follows:

BALANCE SHEET OF X & Y

Assets	$6,000.00	X, Capital	$6,000.00
Cash (paid in by Y)	6,000.00	Y, Capital	12,000.00
Good-will (brought in by Y).....	6,000.00		
	$18,000.00		$18,000.00

The same relation may be expressed by omitting the account for good-will:

BALANCE SHEET OF X & Y

Assets	$6,000.00	X, Capital	$4,000.00
Cash (paid in by Y)	6,000.00	Y, Capital	8,000.00
	$12,000.00		$12,000.00

In all such cases, it is necessary to determine the exact nature of the agreement between the parties; the division of interest between the partners, and what each actually contributes to the new firm.

9. *Division of profits.*—The basis upon which profits and losses are to be distributed to the members of the firm should invariably be stated. If the copartnership agreement does not definitely provide the method of division, the law assumes that the partners intended to divide the profits and losses equally.

There are a number of different ways in which the profits and losses may be shared. Profits may be divided (1) in proportion to the amount of capital contributed by each partner and according to the time such capital has remained in the business; (2) in proportion to the amount of capital originally contributed by each; (3) on the basis of a ratio agreed between the partners, which may be different from the capital ratio.

10. *Illustration of division of profits in proportion to the capital invested and the time such capital has been employed.*—X and Y are partners under articles of copartnership which provide that the profits at the end of the year shall be divided on the basis of the capital invested and the time it has remained employed. The profits for the period amount to $4,120. How much should each partner receive? The capital accounts in the ledger appear as follows:

X, Capital Account

19—		19—	
Mar. 1, Cash....	$2,000.00	Jan. 1, Balance..	$3,000.00
Nov. 1, Cash....	3,000.00	June 1, Cash....	4,000.00
Dec. 31, Balance.	7,000.00	Oct. 1, Cash.....	5,000.00
	$12,000.00		$12,000.00
		191–	
		Jan. 1	$7,000.00

Y, Capital Account

19—		19—	
July 1, Cash....	$2,000.00	Jan. 1, Balance..	$4,000.00
Dec. 31, Balance.	9,000.00	Nov. 1, Cash....	7,000.00
	$11,000.00		$11,000.00
		19—	
		Jan. 1, Balance..	$9,000.00

11. *Solution of problem.*—To solve this problem, we must find first, the average investment of each partner, and, second, what portion of the total profits, $4,120, is to be paid to each. The average investment of a firm may be defined as a fund which, if placed at interest for a given unit of time, will produce the same amount of interest as the various amounts invested by the partners for different lengths of time. Inasmuch as the investments and withdrawals in this instance were all made on the first day of the month, we may compute the average investment using the month as the unit of time. If, however, the investments were not made on the same date, it would be necessary for us to use the day as the unit of time. If we inspect the account of X, we will note that he had the sum of $3,000 invested for a period of two months, after which he withdrew $2,000, leaving his net investment $1,000, which remained unchanged for three months. On June 1st, he invested $4,000 additional which brought his investment up to $5,000, and which amount remained un-

changed for four months, or until October 1st, on which date he contributed an additional $5,000, bringing his capital up to $10,000, which remained invested for one month. On November 1st, he withdrew $3,000, leaving his net investment $7,000, which remained unchanged until the end of the year.

The rule for finding the average investment is as follows: Multiply each amount on the credit side of the account by the number of months or days intervening between the date of investment and the end of the unit period. Make a similar calculation of each of the individual amounts withdrawn, from the date of withdrawal to the end of the period. Subtract the sum of the products of the withdrawn amounts from the sum of the products of the contributed amounts. The difference will be the average investment for the unit period whether this be one month or one day. To find the average investment for one year, divide by 12 or 365. It will not be necessary to do this, however, for the purposes of our problem inasmuch as the division by 12 or 365 would not alter the ratio.

Two methods of solving this problem are presented, the first of which is to be preferred. The advantage of the first method is, that if the investments have been correctly determined the last amount shown will always be the balance standing at the credit of the capital account. Moreover, the addition of the months or days should always total 12 or 365 respectively, thus allowing the calculator to verify his results. The solution is as follows:

X

Jan. 1	$3,000 × 2	$6,000.00
Mar. 1	1,000 × 3	3,000.00
June 1	5,000 × 4	20,000.00
Oct. 1	10,000 × 1	10,000.00
Nov. 1	7,000 × 2	14,000.00
Average Capital for 1 Month....		$53,000.00

Y

Jan. 1	$4,000 × 6	$24,000.00
July 1	2,000 × 4	8,000.00
Nov. 1	9,000 × 2	18,000.00
Average Capital for 1 Month....		$50,000.00

X is entitled to 53/103 of....	$4,120.00	or	$2,120.00
Y is entitled to 50/103 of....	4,120.00	or	2,000.00
Total Profits			$4,120.00

Solution by Second Method

X

$3,000 × 12	$36,000		
4,000 × 7	28,000		
5,000 × 3	15,000	$79,000	
2,000 × 10	$20,000		
3,000 × 2	6,000	26,000	
Average Capital for 1 Month............			$53,000.00

Y

$4,000 × 12	$48,000		
7,000 × 2	14,000	$62,000	
2,000 × 6		12,000	
Average Capital for 1 Month............			$50,000.00

12. *Division of profits on the basis of the amount of capital originally contributed by each partner.*—Under this method of distribution each partner will receive the ratio of the profits that his capital ratio bears to the aggregate capital. Thus, if X contributes $1,000, Y $2,000, and Z $3,000, the aggregate capital will be $6,000; if the total profits amount to $1,200, X will receive one-sixth, or $200, Y will receive two-sixths or $400, and Z will receive one-half or $600.

13. *Division of profits on the basis of capital originally contributed and accumulated by each partner.*—The agreement between the partners may provide that the profits shall be divided on the basis of the capital originally contributed and accumulated by each partner. In the foregoing illustration, the capital at the end of the first year of business would be $1,200, $2,400, $3,600 for X, Y and Z, respectively. Let us assume that after the profits were stated each partner withdrew $200. The capital account would then be as follows: X, $1,000; Y, $2,200; Z, $3,400. In the following year, if profits of $3,300 had been made, the distribution between X, Y and Z would be in the ratio of 10, 22 and 34, instead of 10, 20 and 30 as in the preceding year. Thus, out of the total profits of $3,300, X would receive $500; Y would receive $1,100; Z would receive $1,700.

14. *Distribution of profits on a ratio different from that of the capital ratio.*—Profits may be divided without difficulty upon a basis other than the individual

capital accounts. After the net profits have been stated, they will be divided among the partners on a ratio previously decided by the partners. It will usually be found that this method has been employed to adjust inequalities between the partners. For example, two men may engage in business, one with more capital than the other. The partner having the lesser capital may, however, be possessed of more skill or ability in the particular business engaged in. The skill and ability of this partner may more than outweight his disadvantage on the score of capital. Skill and ability are known as non-ledger assets because we do not keep accounts with them in the ledger, but nevertheless they are often the most valuable assets which a business firm possesses. In such a case, the inequalities between the partners may be adjusted by allowing the partner who possessed the greater skill a larger share of the profits. One man may devote more time to the business than his partner. Inequalities between the partners on this score are frequently adjusted by allowing the partner who spends his entire time in the business a larger salary than that allowed to the partner who devotes only a portion of his time to the business of the firm.

REVIEW

What are the accounting clauses that should be incorporated in every well-drawn partnership agreement?

What difference is there between the accounts of a sole trader and a partnership? How should partnership books be opened? In what ways may profits be divided?

What is the difference between the purchase of an interest in the profits and the purchase of a share in the business?

CHAPTER IV

PARTNERSHIP PROBLEMS DURING OPERATIONS

1. *The importance of the partnership contract.*—When men enter into partnership they are vitally interested in the partnership agreement. In fact one of the greatest "bones of contention" is a vague, badly worded contract and probably nothing in their business life will cause the partners more concern.

2. *Interest allowed on capital, first illustration.*—The attention of the reader has been called in a previous chapter to the importance of clearly providing in the partnership agreement for interest on partners' capital. This point may be further emphasized in the following illustration:

Let us assume that the capital of a firm of three partners aggregated on January 1st, 19— $6,000, of which amount X was credited with $1,000; Y, $2,000; Z, $3,000. The partners share profits and losses in the same ratio as the capital ratio. The articles provide that interest shall be allowed on the capital at the rate of six per cent per annum. Let us assume, in addition, that the profit-and-loss account, prior to the time when interest was charged on capital, disclosed the fact that the firm had neither made a profit nor sustained a loss, i.e., the expenses exactly equalled the income. Following the instructions in

the partnership agreement, profit-and-loss account would be charged with $360 and the partners individually would be credited with interest on their capital at six per cent. The disposition of the debit balance in the profit-and-loss account caused by the charge of interest would be on the basis of the capital ratio, viz., 1, 2 and 3, or $60 to X; $120 to Y; and $180 to Z. The following tabulation will more clearly set forth the status:

	Total	X	Y	Z
Capital at Jan 1, 19—..	$6,000	$1,000	$2,000	$3,000
Add interest at 6%....	360	60	120	180
	$6,360	$1,060	$2,120	$3,180
Distribution of interest charge on basis of profit-and-loss-sharing ratio, viz.: 1, 2, 3....	360	60	120	180
Capital at Dec. 31,	$6,000	$1,000	$2,000	$3,000

From the foregoing it is evident that where the capital ratio and the profit-and-loss-sharing ratio are the same, no change results in the status of the individual partner's accounts, inasmuch as each partner's capital account will be charged in the distribution of the profit-and-loss account with exactly the same amount with which it was previously credited in respect of interest.

3. *Interest allowed on capital, second illustration.* —The result would be different if the profit-and-loss-

sharing ratio differed from that of the capital ratio. Let us assume again that at January 1st, 191–, the total aggregate capital of the firm was $6,000, of which $1,000 was standing to the credit of X, and $2,000 and $3,000 to the credit of Y and Z, respectively. The partnership agreement provides for the allowance of interest on the capital account at the rate of six per cent per annum. The agreement also provides that the profits and losses shall be shared equally. Assuming the same condition with respect to the profit-and-loss account as was assumed above, the following tabulation will clearly reveal the status of the partners at the end of the period:

	Total	X	Y	Z
Capital at Jan. 1, 19—. .	$6,000	$1,000	$2,000	$3,000
Add interest at 6%	360	60	120	180
Capital as adjusted. .	$6,360	$1,060	$2,120	$3,180
Distribution of interest charge on basis of profit-and-loss-sharing ratio, viz.: 1, 1, 1. . . .	360	120	120	120
Capital at Dec. 31,	$6,000	$940	$2,000	$3,060

An inspection of this form will reveal the fact that this method of procedure results unfavorably for the partner having the smallest capital and benefits the partners having the greater capital.

4. *Interest allowed on capital, third illustration.*—Still another difference in result will be obtained if

the capital ratio of all the partners is the same but the profit-and-loss-sharing ratio is different. If we assume the same aggregate capital of $6,000, and the same state of facts with reference to interest and the net result of the profit-and-loss account before the adjustment for interest, the following tabulation will disclose the effect of this method of procedure:

	Total	X	Y	Z
Capital at Jan. 1, 19—..	$6,000	$2,000	$2,000	$2,000
Add interest at 6%....	360	120	120	120
Capital as adjusted..	$6,360	$2,120	$2,120	$2,120
Distribution of interest charge on basis of profit-and-loss-sharing ratio, viz.: 1, 2, and 3.	360	60	120	180
Capital at Dec. 31,	$6,000	$2,060	$2,000	$1,940

As will be seen, this method operates to the detriment of the partner whose share of the profits is the greatest and benefits the partner whose share is the least, because the latter will bear a smaller charge in respect to the interest than his fellow-partners.

5. *Advantages of a fixed rate of interest on capital.*—It is advisable to charge a fixed rate of interest per annum in respect of capital employed in the business. This opinion is based on the assumption that the money if employed in safe investments would earn a fair rate of interest. Thus, profits from business operations are distinguished from a fair rate of

return on capital. Where the capital ratios are unequal it gives to those holding the larger proportion of capital an advantage prior to the division of the profits.

The effect of an omission to charge interest on capital is as follows: (1) If the capital contributed by partners is equal, and if the shares in the profits are unequal, the partner entitled to the smaller share will lose. (2) If profits are shared equally by partners, but if their capital contribution is unequal, the partner with the larger amount invested will lose.

6. *When interest on capital should not be charged to profit-and-loss account.*—When interest is allowed on all of the capital accounts, it should not be charged to the profit-and-loss account as an expense of the business unless the articles so provide. The reason is that the charge for interest provided for under this agreement is not a charge for borrowed money. It is a method of equalizing the share of the respective partners in the profits by allowing to invested capital a fair rate of return and considering that the remainder of the profits, after provision has been made for the earnings of capital as an investment, will be the profit for risk taking.

Therefore, this provision really constitutes a method of distributing a portion of the profits. The charge for interest should be disposed of in the same manner as the remainder of the profits are distributed. The profits from operation, exclusive of the interest charge, will first be determined, then distributed, part

in the form of an interest allowance and the remainder upon the agreed ratio. The case is different if interest is allowed upon excess capital, which a partner has allowed to remain in the business as a loan. The case is also different when interest is charged on a deficiency of capital contribution. In the first place, interest allowed to a partner on excess capital is really interest on borrowed money, and therefore constitutes a proper charge against the income account of the business in the same manner as interest on a bank loan. In the second case, where a partner has failed to contribute the amount he agreed upon, or has allowed his capital account to fall below the agreed amount, the firm would probably be compelled to borrow money at interest for the purposes of the business, and, therefore, the interest charge made against this partner would be credited to the regular interest account of the business.

When an agreement provides that interest shall be allowed on the capital account of all the partners, the entry must nevertheless be made, even tho in doing so the profit-and-loss account would show a debit balance. Thus, in a case where the profits to be distributed were not equal to the aggregate charge for interest allowed on all the capital, the difference between the net profits and the allowance for interest would be charged against the capital account of the respective partners in the ratio in which they were to share profits and losses.

7. *Adjusting interest on capital thru the part-*

ners' accounts direct.—Another method might have been employed in handling the interest on capital as shown on pages 62 and 63. This method consists of an adjustment between the partners' accounts direct, eliminating any entries either thru the interest or profit-and-loss accounts. In the example on page 62 the profit-and-loss-sharing ratio was equal and the capital ratio unequal. The total capital invested was $6,000. The average capital was $2,000. Z, in his capital account would receive a credit of $60 for interest on his excess of $1,000 over the average capital, and X would be charged with $60 for interest on $1,000, representing the difference between his and the average capital. The entry to accomplish this is:

X	$60.00	
To Z		$60.00

In the form on page 63, the profit-and-loss-sharing ratio was 1:2:3. The total capital was $6,000. X, who contributed one-third of the capital, received one-sixth of the profits. Or, expressed in another way, X, who contributed one-third of the capital, would be charged with one-sixth of the losses. His capital account, therefore, is credited with interest on $1,000, the excess of his capital over the average of $1,000 (one-sixth of $6,000).

Y's capital was one-third of the total and he received one-third of the profits or would be charged with one-third of the losses. Hence no adjustment would be necessary in his case. Z, whose capital was one-third of the total, but who was entitled to receive

one-half of the profits, or be charged with one-half of the losses, would be charged with interest on the excess of his capital of $1,000 over the average of one-sixth, or with an amount of $60. The adjustment between the partners, expressed in the form of an entry, is as follows:

Z	$60.00	
To X		$60.00

8. *Comparison of the two methods.*—The difference between the two methods may be briefly stated as follows: the first method not only attempts to adjust the differences between the partners in respect to capital but also attempts to apportion profits as between the part that is representative of a fair rate of return on capital and the profit from business operation. The second method serves merely to adjust the differences between the partners in respect to capital contribution.

9. *Interest on excess or deficit of capital contribution.*—When the agreement provides that interest shall be allowed on the excess capital contribution of any partner, and charged on the deficit in capital contribution, the interest charges and credits are passed thru the regular interest account as a part of the expense or revenue from business operation. Thus, if X, Y and Z agree to form a partnership, the first agreeing to contribute $60,000, the second $80,000 and the third $10,000, but instead have actually contributed $50,000, $50,000 and $20,000 respectively, it

is very evident that X has paid in $10,000 less than he should, Y $30,000 less than he should, while Z has exceeded his contribution agreed to by $10,000. Assuming that interest is charged and allowed at the rate of six per cent, and that the partners share profits and losses equally, the capital accounts as adjusted would appear as follows:

X, CAPITAL ACCOUNT

Interest on Deficit of $10,000	$ 600	Paid In	$50,000
Balance Down	50,000	⅓ of Interest Acct.	600
	$50,600		$50,600
		Balance Down	$50,000

Y, CAPITAL ACCOUNT

Interest on Deficit of $30,000	$ 1,800	Paid In	$50,000
Balance Down	48,800	⅓ of Interest Acct.	600
	$50,600		$50,600
		Balance Down	48,800

Z, CAPITAL ACCOUNT

Balance Down	$21,200	Paid In	$20,000
		Interest on Excess of 10,000	600
		⅓ of Interest Acct.	600
	$21,200		$21,200
			$21,200

INTEREST ACCOUNT

Z, Interest on Excess $10,000		$ 600	X, Interest on Deficit $10,000	$ 600
X, ⅓ of Balance	$600		Y, Interest on Deficit $30,000	1,800
Y, ⅓ of Balance	600			
Z, ⅓ of Balance	600	1,800		
		$2,400		$2,400

If in this case, the profits were distributed in the ratio of 3, 2 and 1 for X, Y and Z respectively, the capital accounts would be stated thus:

X, CAPITAL ACCOUNT

Interest on Deficit of $10,000	$ 600	Paid In	$50,000
Balance Down	50,300	½ of Interest Acct.	900
	$50,900		$50,900
		Balance Down	$50,300

Y, CAPITAL ACCOUNT

Interest on Deficit of $30,000	$ 1,800	Paid In	$50,000
Balance Down	48,800	⅓ of Interest Acct.	600
	$50,600		$50,600
		Balance Down	$48,800

Z, CAPITAL ACCOUNT

Balance Down	$20,900	Paid In	$20,000
		Interest on Excess of $10,000	$ 600
		⅙ of Interest Acct.	300
	$20,900		$20,900
		Balance Down	$20,900

INTEREST ACCOUNT

Z, Interest on Excess of $10,000		$ 600	X, Interest on Deficit of $10,000	$ 600
X, ½ of Balance	$900			
Y, ⅓ of Balance	600		Y, Interest on Deficit of $30,000	1,800
Z, ⅙ of Balance	300	1,800		
		$2,400		$2,400

10. *Treatment of good-will in partnership accounts.*—Reference has been made to the subject of good-will. It is not the intention to discuss good-will exhaustively at this point, except in so far as it con-

cerns partnership accounts. With the sale of a business, the good-will passes to the buyer; the contract of sale may not specify this, but it is implied.

The valuation of the good-will is an important matter at the time of the death or retirement of a partner. In a recent English case (Smith vs. Nelson) it was decided that the out-going partner was not entitled to anything for good-will. This decision was the result of a poorly constructed clause in the partnership agreement. The estate of a deceased partner is entitled to its share of the proceeds derived from the sale of the good-will of a business in which the decedent was a partner.

The occasion for valuing good-will will arise upon the admission of a new member to the firm, or when a going business is bought outright, or upon the dissolution of a firm or the retirement of a member. Even tho a firm has a valuable good-will, as evidenced by its prosperity, it would be incorrect to place this good-will upon the books. Some merchants make the mistake of valuing their good-will yearly and placing it in the business statements of the partnership.

An interesting case on this subject, which is frequently cited, is the case of Stewart vs. Gladstone, decided in England in 1897. A clause in this firm's articles of copartnership provided that the annual accounts should comprise "all particulars that might be susceptible of valuation." One of the partners contended that it included good-will also. Upon this point the court made the following decision:

Then is it a fair construction of these articles to assume that in taking the annual account of the profits of the concern, the partners were going to put a value upon the good-will, so as to allow each partner to take, year by year, out of the partnership the amount of his share of the increase in the value of the good-will? That is really what it comes to. Now, one cannot help feeling that no mercantile man ever dreamt of such a thing. The good-will is not an available asset in the sense that you can draw upon it, or that you can turn it into money, or pay it out to the partners, and I should say with some confidence, not only relying upon my own experience, but having appealed to the Bar in this case, that no one ever saw such a thing in a merchant's accounts.

This conclusion is both good law and plain common-sense. It is evident that nothing can possibly be gained by writing up a good-will account, for assuredly no benefit is gained by padding the asset side of a firm's balance sheet, and at the same time increasing the capital account of the partners.

When one of the partners withdraws, it is necessary to settle with him for his share of the good-will. Thus, if X, Y and Z form a partnership in which the members are to share profits and losses equally, and afterward they disagree, and X is to retire, he is entitled to payment for his share of the good-will. If it be assumed that the good-will of the firm is valued at $15,000, it is evident that X's share is to be valued at $5,000. The better method to employ in adjusting the account upon retirement of X would be to debit the good-will account for $5,000, or the amount which X's share represents. The amount thereof would be credited to X's capital account. The

reason why it is proper to place the good-will upon the books in this instance is that the surviving members of the firm, Y and Z, have purchased the good-will of their partner X and have paid him for it. Such good-will, then, is to become the property of Y and Z, and if it is so desired, may be closed out by charging both Y and Z, $2,500 and crediting the good-will account to close it.

11. *Retirement of a partner from the firm.*—It is not uncommon for one of the members of a firm to retire, and the remaining partners continue the business under the old firm name. The retiring partner will either be paid off in cash or perhaps may take cash and notes for his interest. The remaining partners buy his share in accordance with whatever agreement they may have made among themselves.

12. *Problem.*—The capital account of a partnership showed the following credits:—W, $2,115; X, $1,692; Y, $1,269; Z, $846. On the retirement from business of W the remaining partners bought his share in proportion to their capital. What amounts would have to be provided respectively by the remaining partners, and what would then be their respective proportions of the total capital?

Solution to Problem

X's capital	$1,692
Y's capital	1,269
Z's capital	846
	$3,807

X's share of W's capital, 1692/3807 = 4/9....	$940.00
Y's share of W's capital, 1269/3807 = 3/9....	705.00
Z's share of W's capital, 846/3807 = 2/9....	470.00
	$2,115.00

X's new capital	$2,632	= 4/9 of the whole
Y's new capital	1,974	= 1/3 of the whole
Z's new capital	1,316	= 2/9 of the whole
	$5,922	

13. *Interest on drawings.*—If it is the intention of the partners to charge interest on the drawing accounts of the members of the firm, the partnership agreement must provide for it. We cannot imply that it is the intention to charge interest on drawings when the agreement provides that interest is to be credited on the partners' capital accounts. Partners' drawings may be considered from two points of view. The amount withdrawn may be looked upon as a withdrawal of the capital, as stated at the beginning of the fiscal period; or drawings may be considered sums properly applied against the profits accruing from day to day, altho not as yet ascertained because a balance sheet has not yet been prepared.

The second view is the more logical one, and for that reason a partner should not be compelled to pay interest on the profits which have been earned, and which are, theoretically at least, due to him, altho they have not as yet been stated. Moreover, the amount which a partner may withdraw is commonly specified

in the articles of copartnership, or if the articles make no provision in regard to withdrawals, the partners may agree among themselves as to the amount to be withdrawn. They are in a position effectually to prevent any one of their number from overdrawing his account.

It is not uncommon, however, to permit a partner to draw more than the sum mutually agreed upon, and in this event the partner who has made the overdraft will undoubtedly be compelled to pay interest for the privilege. But if the partners have permitted the overdraft, and no agreement was made and no conditions were laid down previously by the partners themselves, they cannot force the partner who overdraws to pay interest on the overdraft.

14. *Loans of partners.*—A partner may loan money to his firm. The loan may be in the form of excess capital, either contributed or represented by an accumulation of profits—it may or may not be secured by a note of the firm; or the amount loaned may appear in a special-loan account of the partner. The partner who loans the money has clearly risked more in the venture than his fellow-partners, and therefore for his additional risk he is entitled to compensation, in the form either of increased profits or of interest. The latter method of compensating the partner is the more usual. If the loan takes the form of excess capital it would be better to reduce the capital account to the agreed amount and transfer

the excess to a special-loan account, because the books of the firm ought to reflect actual facts.

15. *Interest on partners' loans.*—It is sometimes held, in litigation, that when a partner voluntarily allows money in excess of his capital contribution to remain in the business, he is not entitled to claim interest on the excess. The theory is that if it was intended that interest was to be allowed on excess capital, the partnership agreement would have provided for it. This view has apparently been modified in New York State by a recent decision of the Court of Appeals, to the effect that the law will presume interest in such cases, and if no rate of interest is specified the court will allow the legal rate. When interest is charged on a partner's loan it should be charged to the regular interest account of the business, inasmuch as it is the same as interest on money borrowed from a bank or from an outsider.

REVIEW

Under what circumstances should interest on capital be allowed? What is the effect of an omission to charge interest on capital?

Why should interest on capital be charged to the profit-and-loss account?

What is the essential difference between the method of adjusting interest directly thru the partners' capital account and the other method mentioned in the Text?

Why should interest on the excess or deficit of capital contributions be charged against the profit-and-loss account?

How should good-will be treated in the books of a partnership?

CHAPTER V

PARTNERSHIP DISSOLUTION

1. *Types of dissolution.*[1]—The dissolution, or liquidation, of a partnership may be voluntary or involuntary. In the first case, liquidation is brought about by agreement among the partners, and in the second case by the action of outsiders, who are generally creditors of the firm. It is important to note that the action taken in liquidation depends very largely upon whether the partnership is solvent or insolvent. When the liquidation is voluntary and the partnership solvent, one of the partners usually acts as agent for the firm in the proceedings. Where the partnership is dissolved because of insolvency, the affairs of the firm are usually wound up by the assignee or by a receiver.

2. *Application of assets at dissolution in a solvent firm.*—The assets of a solvent firm are applied as follows: (1) In the payment of firm debts to creditors, exclusive of loans from partners; (2) In the repayment of loans made to the firm by the partners themselves; (3) In the repayment of the capital account of the partners; (4) In the distribution as profits of the residue, if any, to the partners, in the

[1] Before reading this chapter it would be advisable for the reader to review the legal phases of partnership dissolution in the Modern Business Text on "Business Organization."

proportion specified in the partnership agreement; or equally, if the agreement does not provide for any definite proportion.

3. *Application of partnership assets of an insolvent firm.*—Losses from operation, as well as losses on realization and liquidation, are charged against the capital account in the proportion in which profits and losses are to be shared. If any of the partners have contributed money to the firm in the form of loans, the loans are to be repaid next, unless the partners who loaned money to the firm are in debt to the firm on account of capital. Finally, partners must contribute individually to the deficit, according to their respective shares.

4. *Status of a partner's loan in liquidation.*—The loan that a partner has made to his firm cannot be paid until the outside creditors receive what is due them. The reason for this is that it might be necessary to use a part of the money which a partner contributed as a loan for the payment of the partnership debts. Inasmuch as the partners are jointly and severally liable for firm debts, a partner who loans money to the business cannot expect his loan to be repaid until it is definitely known that the assets of the firm will realize a sufficient amount to pay off all the firm's creditors. In this connection, however, it must be noted that if losses on operation, or losses on realization and liquidation, are so great as to wipe out the capital account of a partner who has loaned money to the firm, so much of his loan as

would be necessary to cancel the debit balance in his capital account would be deducted from the amount to be paid to him.

5. *Expenses of liquidation.*—One or more of the partners may be intrusted with the task of liquidating the affairs of the firm. Since this work is not a part of the partnership duties, special compensation is given. When the partnership is insolvent, the liquidation is usually placed in charge of a trustee appointed by a court. The services of the liquidating agent are paid for on such a basis as the statute permits, or upon such a basis as the court to whom he accounts, may deem proper.

When one partner liquidates the affairs of a firm as agent for his fellow-partners, the compensation that he receives should not be charged as an expense of the business, because if it is so charged the liquidating partner will be debited with his share of the expense in the final settlement. The commission or payment that he receives is a private matter between himself and his fellow-partners, who will compensate him. But if an outsider liquidates the affairs of a partnership, the compensation for his services will be charged to an appropriate expense account, and that expense will be borne by all the partners in the proportion in which they share profits and losses.

6. *Treatment of partners' loans illustrated.*—Suppose that M and N are partners who share profits and losses equally; M's capital is $8,000 and N's capital is $10,000. The former has loaned the busi-

ness $10,000, and the latter has loaned $3,000. They dissolve partnership, and the net assets after the creditors have been paid, realize $14,000. To whom shall distribution of this amount be made?

Solution of Problem

M's Capital Account

To ½ Loss of $17,000	$8,500	By Balance	$8,000
		Transfer to Loan Account	500
	$8,500		$8,500

M's Loan Account

To Transfer from Capital Account	$500	By Balance	$10,000
Cash	9,500		
	$10,000		$10,000

N's Capital Account

To ½ Loss of $17,000	$8,500	By Balance	$10,000
Cash	1,500		
	$10,000		$10,000

N's Loan Account

To Cash	$3,000	By Balance	$3,000

CASH ACCOUNT

To Proceeds of Assets	$14,000	By M, Loan %	$9,500
		N, Loan %	3,000
		N, Capital % ..	1,500
	$14,000		$14,000

7. *Comments on the solution of the problem.*—The total aggregate capital and loans of the members of the firm are $31,000, and the assets realized $14,000 in cash. Therefore the loss of $17,000 will be charged against the capital accounts of the respective members of the firm in the proportion in which they share profits and losses, i.e., equally, M is debited with $8,500, and N is debited with the same amount. It will be noticed that this settlement creates a debit balance in M's capital account of $500, which is transferred to his loan account; the net amount, then, that is still due him out of the assets is $9,500. N's account presents no difficulties.

It should be noted that partners' loans in liquidation stand on an equal status and rank equally in payment.

8. *Repayment of partners' capital.*—After the outside creditors have been paid, and the balance due to partners on their loans has been liquidated, the assets should be applied in repayment of the partners' capital accounts. The distribution of assets in liquidation is always made with the capital accounts as a basis at the time the dividend is distributed. It is

often necessary for the liquidating agent to require considerable time for the realization of the assets, and in the meantime the partners may desire to receive a portion of the amount that he has collected. If the capital ratio is the same as the profit-and-loss-sharing ratio, the liquidator may do this without any further trouble.

Difficulty is liable to arise, however, if the capital ratio is different from the profit-and-loss-sharing ratio. It is evident that if there is a great difference between the capital accounts of the partners, and if the partner who has made the smallest capital contribution should be the one who either is entitled to receive the largest share of the profits or is to be charged with the greatest part of the losses, a situation may arise in which the liquidator must be especially careful in paying off the capital accounts of the partners.

9. *Adjustment of capital ratio to profit-and-loss-sharing ratio in liquidation.*—For the sake of illustrating the danger that the liquidator will encounter if he does not bring the capital ratio into agreement with the profit-and-loss-sharing ratio when he pays liquidation dividends, let it be assumed that X, Y and Z are partners, each with a capital account of $30,000. After the payment of creditors and partners' loans, the loss which is to be charged against the respective partners, who share in the ratio of five, three and two, amounts to $24,000. The liquidator has for distribution $33,000 in cash, and he proceeds to distribute it among the partners on the basis of the cap-

ital ratios, after the loss of $24,000 has been charged against them. But additional losses develop, amounting to $24,000, which are charged against the capital accounts of the partners in the ratio in which they share losses. The following tabulation will show the results that will be brought about by the neglect to reduce the capital ratio to the profit-and-loss-sharing ratio.

	Total	X	Y	Z
Capital at dissolution	$90,000	$30,000	$30,000	$30,000
Losses	24,000	12,000	7,200	4,800
Capital as adjusted	$66,000	$18,000	$22,800	$25,200
First dividend	33,000	9,000	11,400	12,600
Capital as adjusted	$33,000	$ 9,000	$11,400	$12,600
Losses	$24,000	12,000	7,200	4,800
Capital as adjusted	$ 9,000	*$ 3,000*	$ 4,200	$ 7,800

It will be noticed that in the payment of the dividends, one partner X, has been overpaid by the amount of $3,000. The liquidator is personally liable to Y and Z for the amount of this overpayment.

If, however, the liquidator had reduced the capital ratio to the profit-and-loss-sharing ratio, this difficulty would have been avoided, as the following statement will show:

	Total	X	Y	Z
Capital at dissolution	$90,000	$30,000	$30,000	$30,000
Losses	24,000	12,000	7,200	4,800
Capital as adjusted	$66,000	$18,000	$22,800	$25,200
First dividend	33,000	1,500	12,900	18,600
Capital as adjusted	$33,000	$16,500	$ 9,900	$ 6,600
Losses	24,000	12,000	7,200	4,800
Capital as adjusted	$ 9,000	$ 4,500	$ 2,700	$ 1,800

On the distribution of the first dividend, amounting to $33,000, the liquidator has applied the cash used in the payment of partners in such a manner as to reduce the capital ratios of the partners to the profit-and-loss-sharing ratio. Instead of $9,000, X will receive only $1,500; Y will receive $12,900, instead of $11,400; while partner Z will be paid $18,600, instead of $12,600. The adjusted capital, after the dividend of $33,000 has been paid, will be $16,500 for X, $9,900 for Y and $6,600 for Z. After this adjustment has been made, all future losses, payments and charges for expense of liquidation, will be distributed on the same ratio—that is, five, three and two.

Altho the distribution is made on the profit-and-loss-sharing ratio, this method has been adopted not because it is proper to distribute liquidating dividends on the profit-and-loss-sharing ratio, but because the capital ratio has been reduced to the profit-and-loss-sharing ratio.

10. *Method by which the liquidator can easily determine the amount to be distributed.*—In the total column the capital remaining after the first dividend is paid amounts to $33,000. To find how much of the dividend of $33,000 is to be paid to X, Y and Z respectively, the liquidator should divide the capital remaining after the payment of the dividend, on the basis of five, three and two. If this were done it would be seen that X's capital would be $16,500; Y's $9,900; and Z's, $6,600.

The amount standing at the credit of X's capital, prior to the distribution of the dividend, was $18,000. If his new capital is to be $16,500, assigned on the basis of the profit-and-loss-sharing ratio, it would mean that out of $33,000 to be distributed, he is to receive $1,500. Then Y's capital, according to the new arrangement, will be $9,900, whereas his present capital is $22,800, and the difference between these two sums, or $12,900, will be the proportion of the $33,000 to be given to Y. By the same method it is easy to show that Z is to receive $18,600 of the $33,000.

It may happen, in such cases, that the first dividend will not be sufficient to permit the reduction of all the capital accounts of the partners to the profit-and-loss-sharing ratio, and that one of the partners will receive nothing from the first dividend. For example, if the first dividend distributed amounted to $30,000, the amount of the aggregate capital after the distribution would be $36,000. Of the $30,000, Y's share would be $12,000, Z's would be $18,000 and X would receive nothing. The remaining capital accounts would then be as follows: X—$18,000; Y—$10,800; Z—$7,200. The ratio is five, three and two. The following tabulation states this in summary form:

	Total	X	Y	Z
Capital as adjusted	$66,000	$18,000	$22,800	$25,200
First dividend	30,000		12,000	18,000
Capital as adjusted	$36,000	$18,000	$10,800	$ 7,200

Of course, according to this arrangement X would receive nothing from the first dividend. If he should

object to this method of distribution the liquidator could withhold all cash and not distribute any of it until he could be certain that he would not be personally liable in case he paid too much to any of the partners.

11. *Other examples of partnership adjustment.*—When a receiver has been appointed to wind up the affairs of a partnership, it is customary to prepare a statement of affairs setting forth the status of the business, on the basis of enforced liquidation. The proceedings are under the direction of a court of competent jurisdiction. Discussion of this kind of statement and of the principles involved in the sale and transfer of the assets of a partnership to a corporation, is postponed until a later chapter.

REVIEW

The same subject is continued in the following chapter and review questions on the two chapters together are found on page 102.

CHAPTER VI

PARTNERSHIP DISSOLUTION ILLUSTRATED

1. *Adjustment of affairs upon retirement of a partner.*—The adjustments necessary upon the retirement of a partner are well illustrated in a case stated by Mr. Leo Greendlinger, C. P. A.

A, B, C and D were partners, having a partnership agreement in writing which contained the following special provisions:—

(1) The capital $100,000 is to be contributed by: A one-half, B one-fourth, C one-fifth and D one-twentieth.

(2) Interest at 6 per cent per annum is allowed on any amount contributed by a member in excess of the required investment and charged on any deficiencies.

(3) Withdrawals are not to be made beyond the salary allowances.

(4) Each partner is allowed a yearly salary, to be drawn monthly or otherwise: namely, A $3,500, B $2,500, C $2,000 and D $1,000. Such salary allowance is to be credited at the end of the year to the drawing account of each partner—an offset against his monthly withdrawals of such salary.

(5) All adjustments among the partners for interest on capital, drawings, etc., are to be made at the end of each year after the trial balance of the ledger accounts has been taken.

(6) On the retirement of a member of the firm, he is to be entitled, in addition to the amount appearing on the credit side of his ledger account, to good-will. The valuation of the good-will is to be one-half the sum of the last two years' net profits of the business for each retiring member.

(7) Profits and losses are to be divided as follows: A, 50 per cent; B, 25 per cent; C, 15 per cent; D, 10 per cent.

2. *Preparation of necessary statements for adjustments.*—On December 31, after the partnership has existed for four years, A wishes to retire. A list of the ledger accounts as well as all the facts and notations necessary for the adjustment in accordance with the partnership agreement is prepared and gives the following information:

Plant and machinery	$ 50,000.00
Purchases of raw materials	200,000.00
Land and buildings	49,600.00
Advertising	1,800.00
Wages (productive)	240,000.00
Accounts receivable	20,000.00
Supplies for factory	2,450.00
Light, heat and power (factory)	20,000.00
Superintendence (unproductive labor)	10,000.00
Light, heat and power (office)	1,000.00
Cash	87,500.00
Packing materials	1,300.00
Salesmen's traveling expenses	6,000.00
Accounts payable	161,000.00
Insurance on buildings and plant	1,200.00
Interest lost	1,200.00
Reserve for bad debts	5,400.00
A, capital account	52,500.00
B, capital account	23,275.00
C, capital account	13,400.00
D, capital account	4,125.00
Notes receivable	76,000.00
Raw material inventory Jan. 1, 192–	13,500.00
Finished goods inventory Jan 1, 192–	19,000.00
Supplies inventory Jan. 1, 192–	16,000.00
Sundry factory expense	7,200.00
Commissions	1,500.00
Notes payable	21,000.00
Taxes on land and buildings	500.00
Trade discounts gained	4,000.00
Reserve for depreciation on plant and machinery	5,000.00
Reserve for depreciation on buildings	2,000.00
Reserve for depreciation on furniture and fixtures	1,000.00
Mortgage on buildings (5 per cent interest)	15,000.00
Allowances on sales	1,500.00
Insurance on stock and fixtures	1,000.00
Freight, outward	1,600.00

Freight, inward	$ 900.00
Cash discount gained	2,800.00
Interest on mortgage	750.00
Finished goods sales	550,000.00
Salaries (including partners)	20,000.00
Furniture and fixtures	7,000.00
A, drawing account	500.00
B, drawing account	500.00
C, drawing account	500.00
D, drawing account	500.00

The net profits for the previous three years were $8,500, $9,300, $6,700 respectively.

The semi-annual interest on the mortgage is payable in January and July.

Of the premium paid on insurance of buildings and plant, and stock and fixtures there is unexpired insurance amounting to $200 and $100 respectively.

The inventories are as follows:

Raw material	$16,750.00
Factory supplies	930.00
Goods in process of manufacture	5,450.00
Packing materials	150.00
Finished goods	20,300.00

It is agreed that the depreciation of various assets at the present should be at the following percentages, on the net balance shown on the respective ledger accounts, after deducting the depreciation of former years as shown by the various depreciation accounts:

On plant and machinery	5 per cent
Land and buildings	2 per cent
Furniture and fixtures	10 per cent

It is also agreed that a reserve of 5 per cent is to be provided for bad and doubtful accounts on the notes and accounts receivable outstanding.

In the first year of the enterprise the partners con-

tributed capital as follows: A, $60,000; B, $20,-000; C, $14,000; D, $6,000. As no interest adjustments were made at the time, the partners agree that such an adjustment is to be made now. The items shown as drawings to B's and C's accounts are not all to be considered as overdrafts on salary. On the contrary, an abstract shows that B and C have not taken out all their salaries, and that there is due to each, after deducting the withdrawals of $500, another $500 on account of salary not withdrawn, while A and D have each overdrawn $500.

After completing the foregoing transaction, the partners decide in accordance with the partnership agreement (clauses 5 and 6) that A is to get in cash one-half of the sum due him and the other half in four notes of equal amounts, payable within two years' time; one note every six months.

The problem, then, is (a) to determine the result of the year's operations; (b) make the proper adjustment entries consistent with the intentions of the partners; (c) prepare a final balance sheet, and (d) show the partners' respective capital accounts.

3. *Trial balance and profit-and-loss account.*—The first step is to find out if the books are in equilibrium and in order to do this we prepare the trial balance given on page 95. In accordance with the best practice the accounts are grouped so as to facilitate the preparation of financial statements.

A profit-and-loss account for the firm for the year ending December 31, 192– shows in the first section

of the debit side the cost of the material used during the year's operation, e.g., the raw material, inventory and the purchases. From this is deducted the raw material inventory as well as the trade discount allowed on purchases. Other charges follow.

The inventory of raw material on hand at the end of the period is shown as a deduction from the purchases, tho it could be entered on the credit side of the same section. The result would be the same, but if the percentage of the cost against proceeds is to be obtained, or a comparison of percentages of different periods is to be found, the deduction of these inventories is preferable to entering them on the credit side.

Goods in process of manufacture are entered on the credit side, because correct results would not be obtained if the expenditure on these goods were charged to the current period, when they are not utilized nor even completed during such period. The balance is carried down as a first charge against the trading section of the profit-and-loss account.

The second section, known as the trading section, contains on the debit side; first, the balance brought down from the manufacturing section, followed by the inventory of finished goods on hand at the beginning of the period, as well as by all the other items pertaining to the trade.

The credit side shows gross sales from which proper deductions are made for the allowances, leaving net sales of $548,500. There is shown also the

amount of finished goods on hand at the end of the period, giving a gross profit of $50,128 on trading.

This balance is carried forward to the credit side of the third section of the profit-and-loss account. Against this is charged all general items of expenditure, such as salaries (including the unpaid salaries due to B and C), general insurance, etc., showing the ordinary business profit to be $25,628. This is carried to the credit side of the final section of the profit-and-loss account, and by adding the cash discount gained, a total of $28,428 is made. Against this amount is charged the interest on the mortgage and general interest, thus leaving a net profit, exclusive of interest on investment and reserve for bad debts, amounting to $26,478.

The reason for dividing the profit-and-loss account into various sections is to present to the best advantage the result of each section.

4. *Preparing a profit-and-loss appropriation account.*—The profit-and-loss account having been completed the profit-and-loss appropriation account is prepared. This account shows the net profit to be distributed among the partners, after provision has been made for reserve for bad debts. The credit side shows the net profits from the profit-and-loss account, amounting to $26,478. It shows also interest charged to B, C and D on account of their deficient investment as well as withdrawals, making a total of $27,000. The debit side shows the five per cent reserve for bad debts on notes and accounts receivable,

amounting to $4,800; also the interest accrued on A's excess investment, after deducting withdrawals, amounting to $120, leaving a balance of $22,080 for allocation among partners. This net profit is allocated according to the provision for dividing profits and losses, namely: to A, 50 per cent, or $11,040; to B, 25 per cent, or $5,520; to C, 15 per cent, or $3,312, and to D 10 per cent, or $2,208.

5. *Verifying the profit-and-loss account and examining financial conditions.*—Next the results shown by the profit-and-loss account must be verified and the financial condition of the concern disclosed as well. The balance sheet on page 99 shows this condition. It will be noticed that the assets are divided into current, fixed and deferred. By deferred assets is meant outlays made under one period for the benefit of a future period. The item here is the unexpired insurance premium amounting to $300. The total assets are $325,378. The total liabilities (divided into current and fixed) amount to $197,000.

The last division of the balance sheet shows the proprietorship and reserves. The reserves deducted for the current period are taken off from each asset, while the general reserves created in previous periods are entered on the liability side. The capital left in the business, after adding the profits made during the period, as well as the accrued salaries of B and C, and deducting the excess withdrawals of the other partners, amounts to $114,978. The problem now required is to show the partners' individual capital ac-

counts, and these are shown on pages 100–101 respectively. B, C and D's capital accounts are self-explanatory. They show the credit balances to each partner at the beginning of the period, January 1, 192–, to which is added the share of profit made during the period, including in B's and C's accounts the unpaid salary, and against which is charged interest. The interest is debited, if there is a deficiency, or credited if there is an excess of capital. At the end appears the balance of capital in each partner's account.

6. *Analysis of transactions in the problem.*—An analysis of the problem shows that it has been necessary to make adjustments among the partners for interest on capital, drawings, etc., which is here shown:

Adjustment account	$660.00	
To A, capital account		$600.00
To D, capital account		60.00
Adjustment of interest on first year's investments as per unanimous agreement.		
B, capital account	$300.00	
C, capital account	360.00	
To adjustment account		$660.00
Adjustments of interest on first year's investments as per unanimous agreement.		

The entry shows a debit of $660 to the adjustment account, and a credit to A for $600 and to D for $60. It also shows a debit to B for $300, and one to C for $360, and a credit to the adjustment account for the $660. These entries represent the adjustment of interest on the first year's investments. This is not carried thru the profit-and-loss account because it has nothing to do with the profits. In this case, if B and C are debited, and A and D credited for the respective amounts mentioned

in the adjustment entry, the result is the same as if the adjustment account was debited and credited for the same amounts. Nevertheless, if the figures disclosed a balance in the adjustment account, if it were debited for only $600 instead of $660, and credited for $660, that balance of $60 would have to be apportioned among the partners in accordance with the provision for sharing profits and losses. In such case the partner or partners who are charged with interest would share in the apportionment, and rightly so. It makes no difference to the business whether the interest is earned by reason of a partner's deficiency of investment, or because the money has been loaned at interest to an outsider.

7. *Debiting or crediting partners' accounts for adjustments.*—After having made the adjustment entries each partner's respective account is debited or credited in accordance with the adjustments. The value of the good-will to which A is entitled, as set forth in Clause 6, is then found. The clause reads, that in case of the retirement of a member of the firm he is to receive for good-will one-half the sum of the last two years' net profits of the business. On page 88 it is seen that the net profit for the previous year was $6,700, to which is added the net profit of this year, $22,080, making a total of $28,780. Therefore, A is entitled to one-half of this, $14,390, and this sum is credited to his account. As four notes totaling $39,075 are issued to A and a like amount paid him in cash, his account is debited for such notes and cash, thus making it balance.

TRIAL BALANCE, DECEMBER 31, 192–

Cash	$ 87,500.00	
Notes receivable	76,000.00	
Accounts receivable	20,000.00	
Raw material inventory (January 1)	13,500.00	
Finished goods inventory (January 1)	19,000.00	
Supplies inventory (January 1)	16,000.00	
Plant and machinery	50,000.00	
Land and buildings	49,600.00	
Furniture and fixtures	7,600.00	
Notes payable		$ 21,000.00
Accounts payable		161,000.00
Mortgage on buildings (5 per cent interest)		15,000.00
Purchases of raw materials	200,000.00	
Wages (productive)	240,000.00	
Light, heat and power (factory)	20,000.00	
Supplies for factory	2,450.00	
Superintendence (unproductive labor)	10,000.00	
Packing materials	1,300.00	
Salesmen's traveling expenses	6,000.00	
Advertising	1,800.00	
Insurance on buildings and plant	1,200.00	
Sundry factory expense	7,200.00	
Commissions	1,500.00	
Taxes on land and buildings	500.00	
Trade discounts gained		4,000.00
Allowance on sales	1,500.00	
Insurance on stock and fixtures	1,000.00	
Freight outward	1,600.00	
Freight inward	900.00	
Cash discount gained		2,800.00
Interest on mortgage	750.00	
Finished goods sales		550,000.00
Salaries (including partners')	20,000.00	
Light, heat and power (office)	1,000.00	
Interest lost	1,200.00	
Reserve for bad debts		5,400.00
Reserve for depreciation on plant and machinery		5,000.00
Reserve for depreciation on buildings		2,000.00
Reserve for depreciation on furniture and fixtures		1,000.00
A, capital account		52,500.00
B, capital account		23,275.00
C, capital account		13,400.00
D, capital account		4,125.00
A, drawing account	500.00	
B, drawing account	500.00	
C, drawing account	500.00	
D, drawing account	500.00	
	$860,500.00	$860,500.00

PROFIT-AND-LOSS ACCOUNT OF THE FIRM A, B, C AND D, DECEMBER 31, 192–

To raw material inventory, Jan. 1		$ 13,500.00		By goods in process of manufacture	$ 5,450.00
Purchases		200,000.00		Balance carried down, being first charge against trading	487,622.00
		213,500.00			
Deduct					
Raw material inventory Dec. 31	$16,750.00				
Trade discount	4,000.00	20,750.00	$192,750.00		
Productive labor			240,000.00		
Unproductive labor			10,000.00		
Light, heat and power (factory)			20,000.00		
Supplies inventory, Jan. 1		16,000.00			
Supplies purchases		2,450.00			
		18,450.00			
Less inventory, Dec. 31		930.00	17,520.00		
Insurance on buildings and plant		1,200.00			
Less unexpired		200.00	1,000.00		
Freight inward			900.00		
Factory expenses			7.200.00		
Taxes on land and buildings			500.00		
Depreciation reserves:					
Plant and machinery (5% on 45,000)		2,250.00			
Land and buildings (2% on 47,600)		952.00	3,202.00		
			$493,072.00		$493,072.00

To Balance brought down, being prime charge against trading		$487,622.00	By gross sales of finished goods	$550,000.00	
Finished goods inventory January 1		19,000.00	Less allowances	1,500.00	
Packing materials	$1,300.00			$548,500.00	
Less inventory Dec. 31	150.00	1,150.00	Finished goods on hand unsold	20,300.00	$568,800.00
Salesmen's traveling expenses		6,000.00			
Advertising		1,800.00			
Commissions		1,500.00			
Freight outward		1,600 00			
Gross profit on trading		50,128.00			
		$568,800.00			$568,800.00
To Salaries (including partners)		$ 22,000.00	By gross profit on trading		$ 50,128.00
Light, heat and power (office)		1,000.00			
Insurance on stock and fixtures	$1,000.00				
Less unexpired	100.00	900.00			
Reserve for depreciation on furniture and fixtures (10% on $6,000)		600.00			
Ordinary business profit		25,628.00			
		$50,128.00			$ 50,128.00
To Interest on mortgage (1 year)		$ 750.00	By ordinary business profit		$ 25,628.00
General interest lost		1,200.00	Cash discount gained		2,800.00
Net profit exclusive of interest on investment and reserve for bad debts		26,478.00			
		$ 28,428.00			$ 28,428.00

PROFIT-AND-LOSS APPROPRIATION ACCOUNT

To reserve for bad debts (5% on notes and accounts receivable, $20,000.00 + $76,000.00)		$4,800.00
Interest credit on excess investment, viz.:		
A, excess investment	$ 2,500.00	
Less excess withdrawal .	500.00	
Net excess	$ 2,000.00 @ 6%	120.00
Allocation of net profits:		
A, 50%	11,040.00	
B, 25%	5,520.00	
C, 15%	3,312.00	
D, 10%	2,208.00	22,080.00
		$27,000.00

By net profits		$26,478.00
Interest debit on partners' deficiencies of investment:		
B, Deficiency investment ..	$1,725.00	
Less deficiency withdrawal	500.00	
Net deficiency	$1,225.00	
@ 6% interest per annum		73.50
C, Deficiency investment ..	6,600.00	
Less deficiency withdrawal	500.00	
	$6,100.00 @ 6%	366.00
D, Deficiency investment ..	875.00	
Add excess withdrawals..	500.00	
	$1,375.00 @ 6%	82.50
		$27,000.00

BALANCE SHEET OF THE FIRM A, B, C and D, ON DECEMBER 31, 192-

CURRENT ASSETS:			
Cash		$87,500.00	
Notes receivable	$76,000.00		
Accounts receivable	20,000.00		
	$96,000.00		
Less 5% reserve for bad debts	4,800.	$91,200.00	$178,700.00
Inventories:			
Raw materials		16,750.00	
Goods in process		5,450.00	
Finished goods		20,300.00	
Factory supplies		930.00	
Packing materials		150.00	43,580.00
FIXED ASSETS:			
Plant and machinery	$50,000.00		
Less 5% depreciation on balance of $45,000 ..	2,250.00	47,750.00	
Land and buildings	49,600.00		
Less 2% depreciation on balance of $47,600 ..	952.00	48,648.00	
Furniture and fixtures ...	7,000.00		
Less 10% depreciation on balance of $6,000 ...	600.00	6,400.00	102,798.00
DEFERRED ASSETS:			
Insurance premium (unexpired)			300.00
			$325,378.00

CURRENT LIABILITIES:		
Notes payable	$ 21,000.00	
Accounts payable	161,000.00	$182,000.00
FIXED LIABILITIES:		
Mortgage on buildings		15,000.00
PROPRIETORSHIP & RESERVES:		
Reserve for depreciation on plant and machinery	$ 5,000.00	
Reserve for bad debts	5,400.00	
Reserve for depreciation on buildings	2,000.00	
Reserve for depreciation on furniture and fixtures	1,000.00	$ 13,400.00
A, Capital account	63,160.00	
B, Capital account	29,221.50	
C, Capital account	16,846.00	
D, Capital account	5,750.50	114,978.00
		$325,378.00

A'S CAPITAL ACCOUNT

Date	Particulars	Amount	Date	Particulars	Amount
192–			192–		
December 31	To personal drawings in excess of salary	$500.00	January 2	By balance	$52,500.00
	Balance	63,160.00	December 31	By 50% of profits	11,040.00
				By 6% interest on excess investment	120.00
		$63,660.00			$63,660.00
192–			192–		
January 2	To cash	$39,075.00	January 2	By balance	$63,160.00
	Notes payable (4 notes each for $9,768.75, payable one each and every six months)	39,075.00		Adjustment of interest on first year's excess investment	600.00
				Good-will as per clause 6 of the partnership agreement	14,390.00
		$78,150.00			$78,150.00

B'S CAPITAL ACCOUNT

Date	Particulars	Amount	Date	Particulars	Amount
192–			192–		
December 31	To 6% interest on deficient investment	$73.50	January 2	By balance	$23,275.00
	Balance	29,221.50	December 31	25% of profits	5,520.00
				Unpaid salary	500.00
		$29,295.00			$29,295.00
192–			192–		
January 2	To adjustment of interest on first year's deficient investment	$300.00	January 2	By balance	$29,221.50

C'S CAPITAL ACCOUNT

Date		Particulars	Amount	Date		Particulars	Amount
192–				192–			
December	31	To 6% interest on deficient investment	$ 366.00	January	2	By balance	$13,400.00
December	31	Balance	16,846.00	December	31	15% of profits	3,312.00
				December	31	Unpaid salary	500.00
			$17,212.00				$17,212.00
192–				192–			
January	2	To adjustment of interest in first year's deficient investment	$ 360.00	January	2	By balance	$16,846.00

D'S CAPITAL ACCOUNT

Date		Particulars	Amount	Date		Particulars	Amount
192–				192–			
December	31	To personal drawings	$ 500.00	January	2	By balance	$4,125.00
December	31	6% interest on deficient investment	82.50	December	31	10% of profits	2,208.00
December	31	Balance	5,750.50				
			$6,333.00				$6,333.00
				192–			
				January	2	By balance	$5,750.50
				January	2	Adjustment of interest on first year's excess investment	60.00

REVIEW

What are the reasons for the dissolution of a partnership?

How should the assets be distributed in the case of a solvent partnership? In the case of an insolvent partnership?

What is the status of partners' loans in liquidation?

How should liquidating dividends be distributed on the capital ratio, or on the profit-and-loss-sharing ratio? Why?

CHAPTER VII

CONSIGNMENTS AND JOINT VENTURES

1. *Legal relation between consignors and consignees.*—The relation that exists between a consignor and a consignee is that of principal and agent. While the rights and duties of both parties are usually regulated by a contract, their relations are governed also, to a large extent, by what is known as "the customs of the trade." A consignment may be defined as a shipment of merchandise, made by the owner or consignor, to another party, called the consignee, who acts as agent for the consignor in disposing of the goods.

There are two kinds of agents—general agents, who represent the principal in all his business, and special agents, whose authority extends to the performance of certain acts only. The important question, in any individual case, is to find out just what the agent's duties are. This authority may be directly conferred by the consignor; or it may be incidental—that is, necessary to certain powers expressly conferred; or it may be implied from the fact that the principal has held the agent out to the world as possessing that authority. In any event it is only when the agent acts within his authority that he can bind his principal.

2. *The factor; his general rights and liabilities.*—The factor, or commission merchant, is an agent to whom goods are sent to be sold. He is a bailee with the right to sell goods in his own name for cash or on the usual terms of credit, at any price; he has also the right to receive the money and to execute and deliver to the buyer a binding discharge. He may also warrant the goods, if they are of the kind usually sold with a warranty. He may take negotiable instruments on a sale on credit. He has a lien on the goods for the balance of the account in his favor, but a voluntary relinquishment of possession destroys the validity of the lien. A factor cannot barter the goods but under the Factor's Acts an innocent pledgee is protected. The statutes known as the Factor's Acts modify the common-law rights and liabilities of the factor; they were passed principally to protect innocent purchasers, who of course cannot know whose goods the factor is selling, or what instructions, with reference to their sale, the owner may have given.

3. *Factor's responsibility for his goods.*—All the rights and duties of both parties may be governed by a contract; when there is no contract the customs of the trade shall govern. The principal is bound by these customs. The factor is obliged to protect the property of the consignor while it is in his possession; he must take such care as a reasonably prudent man would take of his own property. He is not called upon to insure the goods against loss by fire or theft.

4. *Factor's responsibility to his principal; credit.*—If the factor receives specific instructions from his principal, he must follow them absolutely. For example, if he has been advised as to the price at which the goods are to be sold, he would violate instructions at his peril. The factor is also bound to sell the goods at the highest prices obtainable, if no specific instructions as to selling price have been given; and if he sells merchandise on credit for his principal, he is expected to use reasonable prudence and discretion in extending credit. In other words, he must use the same diligence in ascertaining the responsibility of the purchaser, that the average merchant would use. If the factor can prove that he has fulfilled this requirement, he will not be held responsible for the loss caused by a purchaser's failure to pay for goods received.

5. *Factor and secret profit; books of account.*—As an agent, the factor is not entitled to secret profits; he must account for all moneys received in the transaction of his principal's business. Even in the case of illegal transactions, he is required to keep and render accounts. Moreover, an agent who mixes the property or moneys of his principal with his own is liable for any loss that may result.

Inasmuch as his relation to the principal is one of trust, he must act for his principal alone. Thus it has been held that even after an agent has left a principal's employ, the latter may enjoin him from using trade figures that he learned while he was working

for that principal. The factor is bound to give his principal due notice of all information he has gained that may affect the latter's interests. An agent may not buy what he is delegated to sell; therefore factors should not purchase, on their own account, goods which have been intrusted to them for sale by their shippers. Unfortunately some factors are not always honest in this respect.

After the merchandise is sold, the factor must account for it to his principal. In order to be able to do this he must keep proper books of account. While it is generally held that if there is no agreement to the contrary the books of a factor are subject to his principal's inspection, a definite provision to the contrary is sometimes included in the contract, for the reason that information obtained from an inspection of the accounts of a factor would reveal to his principal the merchants to whom the goods were sold. If the factor makes any secret profits, he is of course under the law accountable to his principal for them.

6. *Expenses for which the principal is accountable.*—If the agent has made advances to his principal, it is usually held that he has a lien upon the goods in his possession for the amount of his advances, and that he also has a lien for expenses incurred in the scope of the agency, such as marine and fire insurance carried under instructions, and freight or customs duties paid, as well as allowances made to customers and claims made upon him, in order to protect the validity of his sales to them.

7. *Del credere agency.*—That kind of agency in which the agent guarantees the accounts of the customers who become debtors to the principal thru his solicitation, is known as a *del credere* agency. In the majority of the states of the Union, contrary to the usual rule governing contracts of guaranty, the contracts between the principal and the *del credere* agent do not need to be in writing. In other words, the factor agrees to pay to his principal the price of the goods that have been sold by the time the term of credit extended to the purchaser has expired. Or, if the purchasers fail to pay, the agent must give the principal the price of any goods for which credit has been allowed; thus the principal is relieved of all risk of loss in such cases. Inasmuch as this involves an additional undertaking on the part of the factor, he receives an additional commission, sometimes called a "guaranty," if his agency if of this kind. Of course the factor is not entitled to claim a guaranty on cash sales, since he has assumed no risk in making them. Any transaction under *del credere* agency practically amounts to a sale to the agent and a resale to the customer, altho actually the title to the goods passes directly from the principal to the third party.

8. *Why goods are shipped on consignment.*—There are a number of reasons why goods are shipped on consignment. In the first place, a merchant who disposes of his product thru the agency of a factor is relieved of the burden of developing a market for his goods and of training a sales force. In other words,

he can devote his entire attention to the manufacturing, or producing end of his business. Factors are often called upon to sell a surplus which the business cannot conveniently dispose of thru its regular channels of business. Or sometimes goods will be shipped on consignment to a business house to be sold at a specific price, because the shipper has not sufficient faith in the credit-standing of the consignee to be willing to sell him goods on credit.

9. *Goods on consignment; the consignee's liability.*—When goods are sold outright, the title to the goods passes at once to the buyer; but when merchandise is shipped on consignment, as long as the goods are unsold they remain the property of the consignor. In the latter case, it is the consignee's duty to keep them separate and distinct from his own merchandise, so that they may be readily identified at any time. If the consignee appropriates to his own use either the money he has received for goods sold, or the goods that he still has on hand, he is liable under the criminal law. Since there is also civil liability, the shipper is protected by a double safeguard.

10. *Goods on consignment; live stock and farm produce.*—Live stock and farm produce are frequently shipped to commission merchants to be sold on consignment, because the shipper cannot know at the time he sends them to market what the market price will be when they arrive, and since the goods are perishable it is necessary that they be disposed of as soon as they reach the market. Generally in cases of this

kind the shipper specifies no selling price for the goods, because if the factor should be unable to realize a fixed price the goods would have to be carried, and the shipper would have to bear the carrying charges and whatever loss there might be from deterioration.

11. *Consignment and the retail merchant.*—The retail merchant should be careful not to overbuy. And yet, too great conservatism may mean that he will not have stock on hand when customers are ready and willing to purchase; this would, of course, mean a heavy loss. He may avoid both of these extremes if he can arrange with a wholesaler or a manufacturer to ship him certain goods on consignment. If this arrangement is made, the consignee is protected in the event of his not being able to find a market for the goods. The consignment method enables even the merchant who does not possess the capital necessary to purchase the goods outright, to enjoy all the trading advantages of a complete stock of goods.

12. *Brokers distinguished from factors.*—A broker is an agent who, altho intrusted with the duty of disposing of goods or property, does not actually hold possession of them. For this reason he has less apparent authority than a factor. In dealing with a merchandise broker, the purchaser should be on his guard, for the former has no apparent authority to receive payment for goods, and usually has no right to make a sale on credit or to take negotiable instruments in payment for goods sold. Moreover, he may not warrant the goods.

13. *Mill agents.*—The so-called mill agent is not an agent at all; he is, in reality, an independent contractor who agrees to take and sell the entire output of a certain mill or factory. He actually has possession of the goods, and title to them as well, since the mill actually sells the goods to the mill agent. In other words, a mill agent is a principal, not an agent.

14. *Joint ventures.*—Transactions in which consignments are made for a merchant's own account are sometimes called ventures, or single adventures. Similarly, transactions in which the merchant is a copartner with others, are termed joint ventures, or joint accounts. The members of a venture are partners, but the partnership relation exists only for the carrying out of one or more specified transactions, and terminates as soon as the business has been completed. Thus, a merchant may ship goods to another merchant at another point, to be sold for the joint account of both parties; the second party either furnishes the necessary cash to finance the venture, or perhaps he may ship to the first party a consignment of goods to be sold by the latter, the proceeds to be shared by both parties. Not infrequently three or more individuals are interested in a transaction of this character. This relationship gives rise to a number of complications for several reasons: the contributions of the different members of the venture may be unequal; the goods exchanged between the parties to the transaction may not all be of the same value;

or the cash capital contributions of the members may be unequal.

15. *Accounting procedure in the commission business; general.*—The great variety of conditions in the commission business makes it difficult to discuss its accounting procedure except in a general way. In every case, the records of both the consignor and the consignee should reflect exactly the terms of the contract that binds them both.

Sales made on approval, and the shipment of goods on consignment, must not be entered in the sales account until the factor has disposed of the goods; nor can the factor treat the receipt of merchandise sent him on consignment as ordinary purchases would be treated in books of account. Each party must therefore provide the bookkeeping machinery necessary to record such shipments properly. It is common practice for business undertakings that are in the habit of consigning merchandise to dealers "on sale or return," to treat such transactions in their accounts as if they were actual sales—that is, to charge the account of the customer and credit the sales account. When the balance sheet is prepared at the end of the fiscal period the amounts charged to customers are frequently given an arbitrary valuation; for instance, 66 2/3 per cent of the amount of the face value of such approval sales. The sales account is adjusted accordingly.

16. *Sales on approval, and allowance for deteriora-*

tion.—Even if the valuations were correct it would not be proper to include sales on approval as valid sales in the income account. It would be as incorrect to state under accounts receivable the amount that appears in the customers' accounts, since no sale has taken place. Moreover, the facts set forth in the balance sheet would be misleading.

As long as the goods remain unsold, they should appear as part of the inventory, and should not be carried in the balance sheet under accounts receivable. It is also evident that if the goods consigned consist of clothing or furs, which are subject to radical changes in style, a further adjustment may be necessary, owing to the fact that changes in style are likely to affect the price which may subsequently be realized on merchandise as yet unsold. Very often a manufacturer is compelled to make expensive alterations in garments returned to him from the consignees in order to make them fashionable. The consignor should remember that goods sometimes become shopworn while in the hands of consignees, and that their value is affected accordingly. Evidently, the record of the goods still unsold, in the hands of consignees, should be included in the inventory of finished goods. The valuation will depend upon (1) the present market price; (2) whether or not the goods are subject to changes in style or fashion; (3) whether or not they have deteriorated while in the hands of the consignees.

17. *Freight and storage; consignments occasional*

and frequent.—If freight has been paid on the consigned merchandise, or storage charges have accrued, the question will always arise, whether or not prepayments of this character, with respect to goods as yet unsold, should be treated, at the close of a period, as deferred charges to future operations, or written away directly to profit-and-loss. While the amounts of these items are usually not large, and while it may not make much difference whether or not they are included in the balance sheet, it is necessary, nevertheless, to dispose of items of this character. It would seem that the final disposition of the items would depend upon whether or not there were any reasonable prospect of the consignee's disposing of the goods at a price that would enable the consignor to realize the amount of their cost and the accrued charges.

The accounting procedure will depend also upon whether or not consignments are occasional or frequent; it is clear that the records of a business in which only occasional shipments are made, will differ greatly from those of a business that disposes of most of its products thru the agency of factors. Another question that will have to be considered is, whether consignments should be entered in the financial records at the time they are received, or not until the goods are sold; that is, whether or not memorandum entries should be made in the general books of either party to record the values of goods shipped or received.

It is the opinion of the author that, except in the case of occasional consignments, no entries should be

made in the general financial records of the value of consignments shipped or received, because when this practice is followed the sale of the goods at a later date will necessitate making numerous adjustment entries—a rather crude and time-consuming procedure.

18. *Minimum prices on goods shipped.*—The fact that goods are shipped on consignment does not always mean that a commission is to be paid. Occasionally a business house will consign to one of its customers goods that are billed out at a fixed minimum selling price. The consignee, under these circumstances, has the privilege of selling the goods at any price that he can obtain. If the price that he secures is higher than that which the consignor set, the consignee may keep the difference. This differs from an ordinary sale only in that the consignee does not have title to the goods and that he does not have to pay for them until he has sold them. The more usual case, however, is that in which the goods are consigned, either at a fixed price or at an open price, and the factor who sells the goods receives a commission at an agreed percentage on the amount realized. It is evident that in these cases the factor is doing a strictly commission business, and consequently his profit is derived from commission and not from trading.

19. *Accounts to be kept on the books of the consignee.*—As soon as the factor receives a lot of goods on consignment, he will make an entry in an appropriate memorandum book, fully describing the lot,

and he will enter the numbers, or marks, by which it is customary to identify consignment shipments. Any expenses which the consignee has incurred in handling goods—such as freight, cartage, insurance and duties—is chargeable to the consignor, and when the consignee pays these charges he will open an account with the consignor charging these items to his account. If the consignments are at all numerous, the factor will probably provide for a consignment ledger to be controlled by a controlling account, "consignments," in the general ledger.

If he has made any advances to his shippers, the factor will, of course, charge the account of the shipper with the amounts and credit his cash account, making a notation also on the memorandum record, so as to offset these amounts against the amount of the sales at the time he renders his account sales to the shipper.

20. *Del credere agency and its effect upon the balance sheets of both parties.*—It is evident that when the factor is operating under a *del credere* agency he may regard the charges made to his customers at the time of sale as valid assets. If so, he should treat the balance in the consignment sales account as a liability, because he has guaranteed to his shipper that the amount will be paid at the due date, and has received an additional compensation because of that guarantee. The charge for guaranteeing the account, will be made against the account of the shipper, and will be credited to a guaranty account on the books of the factor. When the proceeds of the sales are guaran-

teed, the shipper will credit the account of the factor with the amount due to him for guaranty, charging an appropriate expense account therefor.

21. *Consignment accounts of live stock and produce commission merchants.*—It is evident that an elaborate system of this kind will not be required by commission merchants who deal in live stock or in farm produce, because of the fact that the goods are usually sold immediately upon receipt and an appropriate abstract sales journal can be devised which will greatly simplify the work of bookkeeping.

At the time each lot is received, it will be given a distinguishing number or mark which the salesman will enter upon all sales tickets. An abstract summary of the daily sales will be made, and at the end of the day these will be itemized by lot numbers and an entry for the total proceeds of the lot will be made in the abstract sales journal. The entries of the day in the abstract sales journal must, of course, agree in the aggregate with the summary of that day's sales. The check for the proceeds is usually mailed to the shipper on the day on which the goods are sold, and the account of the commission merchant with his shipper is then closed. If this method is followed, it is not necessary to open any general ledger account for the consignees in the books of the factor.

In some instances, as mentioned above, the factor will make advances against goods which have been shipped to him; in this event the advances will be charged to the account of the consignor. As soon as

any expenses in connection with the goods have been paid, or any advances have been made, a proper record of the details will be entered in the memorandum consignment record. As any consigned goods are sold, the factor will render an account sales to his principal, unless there is a special agreement between them regulating the time at which accountings are to be made. The details of all sales are noted in the memorandum consignment record, under the headings of the lots affected, and when the account sales is made up, or a detailed record of the sales is prepared, it will be entered in an abstract sales journal.

22. *Abstract sales journal.*—The abstract sales journal, a form for which is shown on page 118, will provide for the following columns: date of sale; account sales number; lot number; marks; number of packages received; name of shipper; net proceeds; advances; a special column for each kind of charges paid by the factor for the account of the shipper—such as freight, insurance, duty and commission; gross proceeds of the sales; folio; name of the party to whom the factor sold the goods; the due date; and a remarks column, in which will usually be entered the date on which the customer of the factor made remittance for the sale—this will ordinarily be the date upon which the proceeds are due to be remitted by the factor to his shipper.

23. *Posting abstract sales journal.*—The gross proceeds of the sales will be charged to the account of the customer of the factor from the abstract sales journal;

ABSTRACT SALES JOURNAL

(Left hand page)

DATE OF SALE	ACCOUNT SALES NO.	LOT NO.	MARKS	NO. & KINDS OF CONTAINER			SOLD FOR ACCOUNT OF	L.F.	NET PROCEEDS	ADVANCES
				BBLS.	BOXES	CRATES				

ABSTRACT SALES JOURNAL

(Right hand page)

CHARGES AGAINST CONSIGNOR					GROSS SALES	L.F.	SOLD TO	DUE DATE	CHECK
FREIGHT	INSURANCE	DUTY	COMMISSION	POSTAGE & PETTIES					

the totals of the columns for freight, storage, insurance, etc., will be posted at the end of the month to the credit of the respective accounts in the general ledger, where they will offset the payments made previously by the factor. The net proceeds will be credited to the account of the shipper in the consignment ledger of the factor.

It should be noted that while the factor has charged the amount of the gross proceeds to the debit of those to whom he sold the goods, these amounts cannot be treated in his balance sheet as accounts receivable, since the proceeds, when collected from the customer, must immediately be remitted to the shipper minus any advances or charges due to the factor. The items are not accounts receivable, therefore, and should not be shown as such in the balance sheet of the factor. For the same reason, the amounts which are credited to the accounts of shippers, but on which payment is not yet due, because the proceeds have not as yet been collected by the factor, should not be treated in the factor's balance sheet as liabilities.

24. *Illegitimate sources of profit.*—It is unfortunately true that factors are not always honest with their shippers, and that there are in this business some illegitimate sources of profits. These take the form of excessive charges against the shipper for freight, duty or storage, or sometimes for claims and allowances which the factor says that he has met. Sometimes, too, the factor will report that he has made sales at an average price, instead of stating the actual prices

that he has charged, and then he will pocket a part of the proceeds of the sales. In other cases the factor may purchase the goods on his own account and sell them on a rising market, thus defrauding the shipper of profits which belong to him.

REVIEW

The same subject is continued in the following chapter. Review questions covering both chapters are found on page 136.

CHAPTER VIII

CONSIGNMENTS AND JOINT VENTURES
(Concluded)

1. *The accounts to be kept in the books of the consignor.*—Each shipment should have a distinctive lot number by which it may always be identified. In many cases it will be advisable to provide for a memorandum sales journal which will be similar in form to the regular sales journal. If the concern makes regular sales, as well as shipments on consignment, it would be advisable to use paper of a different color when the memorandum sales journal is printed. A memorandum charge record will support the entries in the memorandum sales journal. The entries will be posted in the memorandum charge ledger from the memorandum sales journal. All shipments of goods on consignment should be charged with full details, including lot numbers, in the memorandum sales journal. They should be charged either at an arbitrary figure or at an open price; or on the basis of the cost price or the price expected to be realized. The memorandum sales journal should also provide, in addition to the usual columns found in a sales journal, a column for the entry of the date on which the goods sent out on memorandum were either returned or charged to the shipper.

As soon as the factor makes an account sales showing that a certain lot of goods or part of a lot has been sold, the date of the sale and sometimes the number of the charge sales ticket will be entered on the memorandum sales journal, and the account of the factor in the memorandum sales ledger will be relieved by the amount reported on the account sales. There should also be a column provided in which to enter the number of the memorandum return sales ticket and the date when the merchandise was returned unsold by the factor. The use of such a system will enable the shipper to keep constant track, not only of the amount of goods in the hands of each individual factor, but also of the details of quality and kind. Occasionally, the shipper will receive orders for goods which he does not have in stock but which are in the hands of his factors to be sold. In such cases, thru the medium of this record, he is able to call in unsold merchandise held by factors and fill the orders which he has received.

Upon the receipt of the account sales the shipper will credit his factor with the amount of expenses incurred and with any commission to which the factor may be entitled. The shipper will have credited previously any advances made by the factor. He charges him with the gross amount of sales as shown by the account sales. If a remittance has accompanied the account sales, the shipper will credit the factor's account with that amount.

At the time the gross proceeds were charged to the

account of the factor, the shipper will properly credit his consignment sales account; this account will also be charged with the freight, storage, insurance and other expenses which the factor reports he has paid. To the debit of the account will also be charged the cost of the goods shipped on consignment, the corresponding credit being made to the purchase account or to the cost of goods sold account. The net balance in the account will represent the profit on goods shipped on consignment, which can be transferred either to the profit-and-loss account, or to a special profit-and-loss account for consigned merchandise, if it is desired to keep a separate record of the results of the consignment business.

Where a merchant is making regular sales and doing business thru factors as well, it is desirable that he keep separate the details of each line of business. This will enable the merchant to determine which is the more profitable: to maintain his own selling organization and make his sales direct to the trade, or to do business thru factors.

2. *Accounting procedure not difficult.*—Commission accounts seem to offer a number of difficulties to the student of accounting. There is no reason apparently why these difficulties should exist. Accounts are simple enough if one realizes the legal rights and duties of the individuals concerned and gives expression to these legal rights and duties, and to the contract in the books of account. The factor should not deposit the cash which he collects from

the proceeds of sales in his own cash account, or, at least, he shoud deposit only so much as belongs to himself in his personal cash account, and the balance, which belongs to his shipper, he should deposit in a trust account. While this is undoubtedly the procedure which the law provides, it is nevertheless true that this legal distinction is not made in practice by all factors. Theoretically, the factor should keep the cash belonging to each shipper as separate as his merchandise. The exigencies of business, however, usually force the abandonment of this practice and compel the adoption of a loose but more practical method. It is true also that where the merchandise and cash of shippers are not kept separate, the factor renders himself liable to criminal procedure in case the shipper sustains any loss or the factor may be charged with conversion.

3. *How to enter joint transactions.*—Usually one partner in a joint venture is selected as the manager. He will record on his books the transactions of the venture, keeping a record not only of his own participation but also of the participation of his partners. The manager will report to the partners his own transactions and theirs as well. On his books, the manager will charge joint venture account with the cost of the goods, the expense incurred in shipping and other charges, including interest on money invested. He will credit the joint venture account with the gross amount realized. The manager will also credit the partners on his books for their contributions of either

cash or merchandise. Furthermore, any expenses which the partners individually may have advanced or paid on account of the venture the manager will likewise credit to them, and charge them with any proceeds which they may have retained. Similar accounts will be kept with respect to the venture on the books of the other partners.

Thus, if partner "A" is the manager and receives contributions of merchandise from partner "B" and cash from partner "C," he will debit the venture account with the value of the merchandise contributed by "B" and the cash contributed by "C," crediting respectively their accounts with the amounts. Partner "B" would debit the venture account on his books with the amount contributed by him, and credit his own merchandise account or purchase account with the goods which he has contributed to the venture. Partner "C" will likewise record on his books the cash which he has contributed to the venture. In addition, Partner "B" would debit the venture account and credit an individual account with Partner "C" for the cash contributed by the latter. Partner "C" would proceed in like manner.

When all the entries have been made upon the books of all the parties, the balance in the joint venture account should be the same on the books of each. Each partner will have on his books an account with his fellow-partners showing the amount of their interest in the venture. The joint venture account is closed by transferring the profit or loss to the personal accounts

of each of the participants, in the proportion in which they agreed to share profits and losses; the manager of the venture will, of course, credit his own profit-and-loss account for his portion of profit in the venture.

If the accounts are handled in this manner, it will be possible at all times to tell the status of the venture, and to determine the equity of the partners therein. It is obvious that the amount standing at the debit of the joint venture account on the books of any member, less the amounts standing at the credit of the partners' accounts, will be an asset in his balance sheet, should the books be closed before the venture has been completed. In some cases, by special agreement, the manager of the venture is allowed a small percentage on the sales to remunerate him for the time and trouble which he has taken individually for the general benefit.

4. *Equation of accounts.*—A debtor may desire to pay several amounts, due at different dates, in one amount. The process of finding the time when the various sums may be paid without loss of interest to either party is called equation of accounts or averaging accounts. The date upon which these sums may be paid without involving such a loss is known as the equated date of payment. It is often necessary to determine the due date of the net proceeds of an account sales. For this reason, therefore, it will be desirable to explain the process.

5. *Simple equation.*—Simple equation is the proc-

ess of finding the average due date in the case where the items of an account are all on the same side of the ledger account, i.e., either all debits or all credits. The equated date may be obtained either by the interest method or by the product method. In solving the equation it is necessary to assume some date as the point from which to measure the time. If the interest method is used it will be more convenient to select January 1 or December 31, because interest tables usually show the number of days elapsed between either of these days and any other dates in the year. Any date, however, may be assumed, and any rate of interest may be used in making the calculation. The assumed date is called the focal date. It is customary to use the interest rates of six per cent or twelve per cent in making the calculations.

6. *Rule for finding the equated date under the interest method.*—Having selected an assumed date of settlement, the next step is to determine what the loss or gain in interest would be to the payer if he paid all the bills on that date. When this amount has been determined, it is necessary to find the number of days that it would take the total amount of the bills to produce in interest a sum equivalent to the loss or gain of interest. The true date of settlement is found by counting forward or backward the number of days so found from the assumed date. It will be evident that if the sum of several bills is $500, and if the loss of interest to the payer is $10 at the assumed date of settlement, the date at which there

would be no loss of interest must be four months after the assumed day, because $10 is the interest on $500 at 6 per cent for four months.

7. *Rule for finding the equated date of an account under the product method.*—In employing the product method the first step consists in finding the due date of each item; the earliest date is assumed as the date of settlement for all the items. Each item in the account is multiplied by the number of days intervening between the focal date and the date of the item. The next step is to determine the quotient found by dividing the sum of the products by the sum of the account. If the focal date is on or before the earliest due date in the account, the quotient will be the number of days after the assumed date, that is, the day on which there will be no loss of interest to either party. This date is the average due date. When the assumed or focal date is selected at, or after the latest day, the resultant above mentioned will be the number of days before the focal date. If there is a remainder left in dividing the product by the sum of the account, disregard the fraction if it is less than one-half; if the fraction is greater than one-half, add one day to the integral number of days in the quotient.

8. *Illustration of product method.*—This method of settling debts is, in principle, theoretically correct, but if applied will often work a great injustice; moreover, it cannot be legally enforced. The principle is illustrated in the following example:

A. Jones

Due April 10	$100 × 0 =	0	
Due April 26	200 × 16 =	3,200	
Due May 22	400 × 42 =	16,800	
Due June 6	500 × 57 =	28,500	
	$1,200	) 48500(40 days	
		) 48000(	
		500	

Due date is 40 days after April 10, or May 20.

9. *Compound equation.*—The process of finding the equated date of payment of the net proceeds of an account sales is a problem in compound equation. The principle involved is merely an extension of the rule for single equation. The problem is to find the due date of the balance of the account, or to find the average of both sides combined. The average due date may be found either by the interest method or the product method.

10. *Rule for finding the equated date of payment of an account having both debit and credit items under the product method.*—The first operation consists in finding the due date of each item; the earliest due date is selected as the focal one. This date must be used for all items on both sides of the account. The next operation is to multiply each item on the debit side of the account by the number of days intervening between the focal date and the due date of the item, and then to find the sum of the products. The third operation consists in proceeding in the same manner with the items on the credit side of the account, care

being taken to use the same focal date. The last operation is to divide the difference between the sum of the debit products and the sum of the credit products by the balance of the account. The resultant will be the number of days intervening between the focal date and the true date of settlement.

It may happen on certain occasions that the sum of the credit products will be greater than the sum of the debit products, altho the balance in the account may show a debit excess. The reverse situation may also occur, that is, a credit balance will appear in the accounts, and there will be an excess of debit products over credit products. In these cases, the rule is to count forward from the focal date, when the balance of the account and the balance of the produce are on the same side, i.e., either both debits or both credits. When the balance of the account and the balance of the products are on opposite sides the rule followed is to count backward. It should be noted, however, that the rule for counting forward or backward is the reverse of the above if the last date is taken as the focal date. Attention is called to the following example showing the method of finding the equated date of payment of an account having both debit and credit items:

EXAMPLE OF COMPOUND EQUATION

JONES IN ACCOUNT WITH SMITH

1920					1920			
June	6	Mdse. 30 days	100. —		July	26	Cash	300. —
	20	" 60 "	600. —		Aug.	10	"	250. —
July	5	" 3 mos.	470. —		"	10	Mdse. 60 days	513
July	28	Mdse. 90 days	438. —					

SOLUTION

Date of item	Due date	Dr. Amount	X	Product
June 6	July 6	100	0	0
20	Aug. 19	600	44	26400
July 5	Oct. 5	470	91	42770
28	26	438	112	49056
		$1608		118226
		Cr.		
July 26	July 26	300	20	6000
Aug. 10	Aug. 10	250	35	8750
Aug. 10	Oct. 9	513	95	48735
		$1063		$63485
		$ 545		)54741(100 days After July 6th or Oct. 14th.

11. *Determining the due date of the net proceeds of an account sales.*—An account sales, altho frequently made out in statement form, may be viewed as an ordinary ledger account, having items on both the debit and the credit sides. The items on the debit side of the account will be the charges which the factor has made against his shipper for freight, insurance, duty, etc., as well as for cash advances. On the credit side, the sales made by the factor are entered. The question that will arise here will be that of determining whether the date to be taken for the items on the credit side is to be the date of the sales, or the due date of the sales. It is advisable to enter the items on the credit side of the account as of the due date of the sales, because the factor will not receive payment until that time.

Some merchants consider that commission and guarantee are due on the average date of the sales;

others, on the average due date of the sales; and still others on the date when the account sales is rendered. This is a matter to be settled by agreement between the parties. The charges for transportation, cartage, duty, insurance, etc., which have been paid by the factor are considered as being due on the date when the factor paid them. It is clear that when these matters have been determined, the process of finding the due date of the net proceeds of an account sales is nothing more than a problem in compound equation.

12. *Accounts current.*—An account current, as its name implies, is a running account; the balance due is called the cash balance. Where two concerns have dealings, one with the other, and the transactions are mutual debits and credits, there will be an agreement made between them that the balance of the account is to be stated at a definite date, such as monthly, quarterly or annually.

Furthermore, it is usually agreed between the parties that interest shall be allowed on the items in the account at a definite rate of per cent, the charge for interest running from the date of each item, or from the due date of each item to the end of the stated period. It is customary, also, for one or both parties to make up a statement of the items appearing in the ledger account, showing in the first column the date of the charge made; in the second, a full and complete explanation of the charge; in the third, the amount of the charge; in the fourth, the number of days elapsed between the due date of the item and the

date of the adjustment, that is, the date on which the cash balance is to be determined; and in the last column, the amount of the interest on each item.

A similar statement is made up for the items that have been carried to the credit of the account. The difference between the interest debits and credits will be debited or credited to the account, as the case may be, and the balance in the ledger account, plus or minus the excess of interest, will be the cash balance due. The amount of the interest is debited or credited to running account in the ledger, and the adjusted balance draws interest for the next period. It is evident that if the account current with B on A's books normally shows a debit excess, it would be more advantageous from A's point of view for the account to be stated monthly than quarterly, because when interest is added to the account, it draws interest for the next period. If any adjustments have been made in the account, such as a charge upon which credit was later allowed, the date of the credit would relate back to the date on which the charge was made.

When the balance has been accepted by both parties without objection, it is presumed to be correct. The account is then called an account stated and cannot be subsequently reopened unless for some gross error or fraud.

Occasionally, in making up an account current, certain items will fall due after the date of settlement. In this event, the interest on such items will be transferred to the opposite side of the account.

13. *Another method of finding the cash balance.*—Where the number of items in an account is small, the account current may be averaged, in the manner described above, for the process of finding the equated date of payment of an account having items both on the debit and credit side. The amount due on the date on which a cash balance is to be determined will be found by reckoning the interest on the balance of the account from the average due date to the date of settlement. For example, if the average date is later than the date of settlement, interest for the number of days difference would be subtracted from the balance of the account. If the average due date was earlier than the date of settlement, interest for the number of days difference would be added to the balance of the account.

In calculating the cash balance on an account current, it is customary to use the interest method because of the fact that interest tables are now in common use, and the interest due on each individual item is shown. Where the amounts involved are large, the product method becomes unwieldy, by reason of the large totals resulting when the amounts are multiplied by the number of days intervening.

14. *Interest on partial payments.*—While the method of averaging accounts, or the method described above for treating accounts current, is customarily used between merchants, for short term obligations, or where the amounts involved are small, yet where a debt has more than a year to run, the inter-

est on partial payments is usually figured by the method known as the United States rule. This rule takes its name from having been approved by the United States Supreme Court. It has also been made the legal rule in many of the states.

Under this method, payments that are made on debts drawing interest are first applied to reduce the amount of the interest accrued to the date of payment; any excess remaining, after the payment of the interest, is used to reduce the amount of the principal of the debt. If, however, any payment is made less than the amount of the interest accrued, the principal sum remains unchanged until the next payment. The balance of interest unpaid is not added to the principal, as this would be compound interest which may be illegal. The balance of the interest due is carried forward, and added to the further interest accrued and due at the time of the next payment. If the next payment is sufficient to pay, not only the former unpaid interest, but also the accrued interest on the principal for the last period, the excess, if any, is applied to reduce the amount of the principal. On the other hand, if the amount of the last payment is not sufficient to pay the aggregate of the first unpaid interest, and the interest accrued for the last period, there will still be a balance of interest to carry forward to the next period in exactly the same manner as that previously described for the original unpaid interest.

REVIEW

How would you differentiate between factors, brokers, mill and *del credere* agents?

What are the reasons for selling goods on consignment?

What is a joint venture? How are the accounts of a joint venture handled? Would you be able from memory to draw up a form for abstract sales journal? Could you outline a system of accounts for a commission merchant, following the suggestions contained in the Text?

CHAPTER IX

FIDUCIARY ACCOUNTING

1. *Examples of fiduciary relations.*—In the discussion of consignment accounts, and in the chapter which follows dealing with statements of affairs and realization and liquidation accounts, the prerogatives of persons charged with responsibility for an estate often replace those of the actual proprietors. The agent accounts to his principal; the receiver or assignee accounts to the court which appointed him. These are examples of what is known as the fiduciary relation, of which there are many other common instances: a guardian is a fiduciary charged with the administration of the affairs of a ward; a commission in lunacy is charged with the management of the estate of one who is adjudged mentally incompetent; an executor is a person named in a will to whom is delegated the duty of administering and distributing the estate of a decedent in the manner provided in the will; an administrator is a person charged with the duty of administering a decedent's estate, and is an officer of the court appointed to administer the estate of a decedent who died without a will; an administrator may also be appointed where an executor named in a will cannot act; a trustee is one who manages the affairs of a beneficiary. From these in-

stances it is possible to frame a definition of a fiduciary—a person who discharges duties imposed by a position of trust or confidence.

2. *Legal duty of fiduciaries to make accountings.*—The accounting of these various fiduciaries should show the assets with which they were intrusted, the increase or decrease in these assets during the period of the trust, and the assets at the time of the accounting. The rights and duties of each of these fiduciary positions are clearly outlined in the law, and it is important that the affairs of the trust shall be administered strictly in accordance with the provisions of the statute. Each fiduciary must account to a court of competent jurisdiction. In most states the law does not lay down any required method of bookkeeping, nor any required method of making a fiduciary accounting. In general, however, it will be wise for the fiduciary officer to follow the form to which the court to which he must report is accustomed.

3. *General duties of all fiduciaries.*—The first duty of a fiduciary is to collect the assets of the estate with which he is charged and to file an inventory with the court. He will then determine the liabilities which are chargeable against the estate he is administering; in the case of an executor or administrator this schedule of liabilities is not filed at the time the inventory is filed, because the executor or administrator may not be at that time aware of all the debts outstanding against his trust estate.

The executor derives his authority from the will and

from the letters testamentary which are issued to him by the surrogate or other court officer charged with the duty of administering the estates of decedents. In the case of executors and administrators the law usually provides that they shall advertise for the claims of creditors, and if the estate is solvent, pay out of the assets which have been realized the amounts due. The statutes of different jurisdictions provide the order in which debts shall be paid; in most cases, debt due to the United States or to the state or municipality must be paid first, and next the expenses of administration. Docketed judgments are paid before unsecured claims. If there is more than enough in the estate to pay these, the unsecured debts of the decedent are then paid. When the debts have been paid, the executor will distribute the principal and income to the beneficiaries according to their interests.

4. *Corpus and income distinguished.*—In most estates, there will be a certain amount of income earned during the period of trusteeship with which the executor will charge himself in his accounting. It is his duty to see that all income is collected promptly, and if the income is payable to one individual and the principal or corpus of the estate is payable to another, it will be necessary for the executor to make proper separation between principal and income as of the day of death. Those assets of which the decedent died possessed are known as corpus; all other increase in the estate is income, with this exception, that if any of the assets of which the de-

cedent died possessed are subsequently sold at an increase over the appraised value, such increase is treated as an increase of corpus. It is interesting to note here that the Federal Income Tax law treats such increase as income of the estate upon which the income tax must be paid by the executor.

In some cases, the fiduciary relation extends over a period of years, and in this event, the fiduciary has the duty of reinvesting the assets in those investments which in his jurisdictions are legal investments for trust funds. During all his service, the fiduciary is chargeable with due care and prudence in the management of the property.

In some cases, the executor is also the trustee, and in comparing the duties of the executor with those of the trustee it will be noted that the executor's duty is primarily the conversion of the assets into cash and its distribution to whom it may concern, while that of the trustee consists of investment and reinvestment and the business management of his trust. The trustee will distribute the income to the life tenant, and the payment of the remainder or the principal of the trust is made to those to whom it may be due and at the time when it is due, under the provisions of the will.

5. *Accounting procedure for executors.*—The executor should keep his records on the double entry basis because of its greater convenience. Moreover, accounts kept by this method lend themselves readily to an audit and to a more scientific method of recording the transactions than do accounts kept ac-

cording to the single entry system. The executor should open such accounts in the ledger as will facilitate the preparation of the schedules which he must furnish in making his accounting to the court. This necessity further implies that the explanation of the transactions in the ledger account shall be full and complete with all details, so that the executor will be able to make his accounting from the face of the ledger without referring to any other data. The executor will also use a journal and a cash book. The former is used not only for entries that cannot be conveniently recorded in the cash book, but it may also be used as a memorandum book for the entry of any important facts which transpire during the period of his administration. The executor's ledger is opened by a journal entry debiting the inventory and crediting the estate or corpus account; the individual assets mentioned in the inventory will each have a special account, the value for which, set up in the ledger account, will be the amount which was entered in the appraisal of the estate made and filed with the court.

When the executor has converted the assets into cash, the cash account will be debited and the asset account credited; if any of the assets realize more than the appraised value, the excess over the inventory values should be credited to a special account, "increase of corpus," which is an adjunct of the estate account, and which it will be necessary to keep because the fiduciary is ordinarily required to account not only for the assets listed in the inventory, but for

increases in the value of such assets and also for any assets discovered after the original inventory was prepared. Should any of the assets fail to realize the inventory value, the difference between the inventory value and the sales price will be debited to a special account "decrease of corpus," which is also an adjunct of the estate account, and which will form the basis of a separate schedule showing the decrease in the corpus while in the hands of the executor. The executor will pay the administration expenses charging them to an account, "testamentary expenses"; the debts of the testator will be charged to a special account, "debts"; the expenses of administration will be separated as between those which are chargeable to principal or to corpus, and those which are chargeable to income. From time to time the executor may collect income, which should be credited to a special account for income, and will form a separate schedule in his accounting. After the legal time has elapsed for the presentation of claims of creditors if the estate is solvent, the executor may begin to pay the legatees the amount provided under the will, or if there was no will, he will distribute to the heirs-at-law or next-of-kin, the amounts due to them, under the provisions of the statute for such cases. Payments to legatees will form a special schedule and each legatee should have a separate account in the ledger.

6. *Executor's accounting.*—The executor's accounting will be ordinarily in the form of an account of charge and discharge. He will charge himself

with the inventory, listed in a separate schedule; he will charge himself with the amount of increases realized on the sale of assets over the inventory values thereof; he will charge himself for assets which were not included in the inventory, that is, assets discovered after the filing of the inventory. He will also charge himself with all income collected.

He will then credit himself with the decreases in corpus caused by the sale of assets for less than their inventory value; he will credit himself with the amount which he has paid out in testamentary and funeral expenses; he will also credit himself with the amount which he has paid out for debts and claims against the estate of the decedent; he will also credit himself for payments made to legatees. The balance between the total charges and total credits will disclose the balance of the estate in his hands on the date of the accounting, which will be cash, or cash and unrealized assets, which are carried forward to the next accounting, or which will be distributed in such manner as the will or the court may provide.

It will be noted that the two essential elements involved in the accounting of executors are corpus and income. Corpus is represented by the original inventory of the estate, and the subsequent increases thereof in accordance with the provisions of law as to what constitutes corpus; this aggregate will be subject to deduction for all of the decreases in corpus due to the sales of assets for less than their appraised value, and for all legitimate expenses of administration

and debts which are chargeable against it. Any further increase in the estate must of necessity be income.

If the executor will plan the accounts in the ledger in accordance with the form in which he is to make his accounting to the court, it is obvious that at the date of his accounting, the preparation of the necessary schedules for approval of the court will be a simple matter, always provided, of course, that he will enter in the ledger accounts full and complete explanations with the entry of monetary values.

7. *Difficulty of differentiating between corpus and income.*—It is not always an easy task to determine whether any particular cash received should be credited to corpus or to income. Inasmuch as the executor or trustee is entitled to the services of competent counsel, the expense of which is chargeable to the estate, he should be careful to follow the law, or in case of doubt, secure an order from the court in transactions involving differentiation of corpus from income. For example, the rules for the apportionment of stock dividends as between corpus and income vary in different jurisdictions. Therefore, the services of a competent attorney are in almost all cases an absolute necessity to the executor. Any doubtful items should, of course, be charged against income, pending the final adjudication. Difficulties will also arise in the case of trustees where investments are made in bonds, if the purchases have been made at a premium. It is evident that if bonds are purchased at a premium

the owner of the bonds will receive par only on the maturity date, and the difference between the premium paid and par will be a loss. Theoretically, at least, the amount of this loss should be charged against income received from the bonds, but in some cases it would be incorrect for the executor or trustee to charge the amortization of the premium against the income of the estate or trust. This will hold true in cases where the will specifically provides, for example, that the life tenant shall receive absolutely all the income of the estate.

8. *Additional duties of executor.*—After the executor's accounting has been approved, all the accounts on the ledger, with the exception of the cash and other assets remaining on hand, will be closed into the estate account; the aggregate of the assets undisposed of and the cash on hand will, of course, equal the amount standing at the credit of the estate account.

The executor must also make the annual report required of fiduciaries by the Federal Income Tax law. Several states have adopted inheritance tax laws under which the executor is chargeable with the tax, altho the tax is levied against the beneficial interests distributed by the will; this means that while the tax follows the property, the executor is held personally liable for its collection. He should therefore either receive payment of the amount assessed against any legatee, or deduct it himself in paying over the legacy.

9. *Commissions of executors.*—The executor's commission is either fixed by law or determined by the court, altho in some cases, the will provides for the specific compensation which is to be paid to the executor. The executor, however, is not obliged to accept the compensation provided for in the will unless he so desires, but in most jurisdictions he must indicate, upon his acceptance of the trust, whether he elects to take the statutory compensation or the commissions provided by the will.

In essence, then, the accounting of the executor is little more than tracing the changes from the initial inventory to the final inventory which, of course, should be reflected in the cash account. There is, however, an exception to be noted; this arises from the payment of specific legacies which are gifts of a specially designated portion of the testator's estate. The title in these legacies vests in the legatee at the date of death, but he cannot secure his gift until it is transferred to him by the executor. Such legacies are subject to inheritance taxes and may not be paid if the estate does not realize a sufficient amount to pay the debts and administration expenses.

10. *Status of real property.*—The statutes of most states provide for the order in which the debts against the deceased shall be paid. In most jurisdictions the statutes will provide also for a detailed list of the property which is subject to the executor's control. For example, real property does not come into the possession of the executor unless thru special provi-

sions in the will containing a power of sale, or unless it is necessary to sell real estate for the payment of debts. The contract made by a testator to purchase realty is a debt of the testator, and must be paid out of the personal estate, altho the property, when paid for, will become the property of the heirs-at-law. On the other hand, when the testator has entered into a contract to sell realty, he has indicated his intention of disposing of it and of converting it into personalty, and therefore the proceeds, when realized by the executor, are part of the personal estate of the testator.

11. *Heirs-at-law and next-of-kin distinguished.*—The personal effects of the decedent are distributed in accordance with the will of the testator; if the testator left no will, distribution of the personal property must be made in accordance with statutes known as the "statutes of distribution." Real property is distributed in accordance with the statutes known as the "statutes of descent." Those who take real property are known as heirs-at-law, while those who take personal property are known as next-of-kin. Usually, but not necessarily, the heirs-at-law and the next-of-kin are the same individuals.

The residuary estate is that portion of the personal property of the testator which he has not effectually disposed of by will, or which is left after all gifts mentioned in the will have been paid. If the will does not contain a residuary clause providing for the distribution of the excess, then distribution will be made

according to the statute of distribution, to the next-of-kin. Further discussion of the subject of the accounts of executors and trustees is not called for in this volume, but it should be noted that the accounting principles are not difficult, and that the accounting must follow strictly the law and the provisions of the will. No special books are required, except in the case of large estates, where it would probably be well for the executor to provide himself with a columnar ruled cash book for the purpose of reducing the mechanical labor of posting.

12. *Definition of trust.*—A trust is defined as the right, enforceable in equity courts, to the beneficial enjoyment of property the legal title to which is in another person. Generally, three persons are concerned in a trust—the creator, who originally owned both the legal and the equitable trust; the trustee to whom is given the legal title; the beneficiary, who has the equitable right to the benefits of the property.

The relation between trustee and beneficiary is known as the trust relation. The rights and liabilities or duties of the several parties to the relation are well established in law. Many of the incidents of the relation are attributable in part or in whole to other relations, but the law recognizes differences between the trust and other relations that amply warrant the difference in names used. Thus, the agent has many of the duties of the trustee. He is said to occupy a fiduciary relation to his principal. But the agent, in making contracts, usually binds his principal while

the trustee binds himself. In the sections following, the incidents of the trust relation will be briefly explained.

13. *Express and implied trusts.*—Trusts may be expressed or implied. Express trusts are created by the voluntary acts of the creator. If the subject matter of the trust is real estate, the trust must be created in writing. If it is personal property, spoken words will serve to create a trust.

Implied trusts are created by operation of law in cases where persons who technically have a legal title are not equitably entitled to it. Suppose, for example, A gets the legal title to B's property by fraud. Equity will regard A as a trustee for B's benefit.

14. *Passive and active trusts.*—Passive trusts, sometimes called simple, technical, dry or naked trusts, are those in which the trustee is a mere depositary of the subject of the trust but has no active duties to perform. Active, special or operative trusts are created in cases where the trustee is committed by the creator of the trust to do some act requiring the exercise of judgment in connection with the administration of the trust. Active trusts become passive trusts when the trustee has no further duty to perform. Under the law in most jurisdictions passive trusts are practically non-existent, for as soon as the title to the property gets into the hands of the trustee the trust is said to be executed; and title, both legal and equitable, is vested in the beneficiary.

15. *Who can be a trustee.*—Any person may become a trustee, but only persons having legal capacity to contract should be made trustees. Corporations known as trust companies are frequently chosen to act as trustees. Their duties are in the main the same as those of natural persons. If a valid trust is created and there is no trustee, either because none has been appointed or because the one appointed is incompetent and refuses to act, an equity court will supply the trustee to perform the trust.

16. *Powers and duties of trustees.*—A trustee has such power as is necessary to carry out the purposes of the trust in the manner prescribed by the creator. He can be relieved of his duties only by consent of all beneficiaries or by turning the property back into the hands of an equity court. Thus, the trustee after he has accepted the trust, is bound to carry out the trust in the manner prescribed, using the property in such a way as any prudent man, giving due diligence to the matter, would handle his own affairs under like circumstances.

Probably the most important prohibition upon the power of a trustee states that he may make no private profit out of the trust estate and he must not mix its property with his own property. Thus, a trustee may deposit money temporarily in a bank, awaiting a reasonable opportunity to invest it, but if he leaves it there unreasonably or if he deposits it to his own personal account, and the bank fails, he personally will have to take the loss.

It will be seen, therefore, that while a trustee does not have to accept the trust, if he does do so either expressly or impliedly, he will be compelled to administer it actively and faithfully.

It must be remembered that the legal title to the subject of the trust is vested in the trustee. As a natural incident to this rule, the trustee, not the beneficiary, is the person charged with the duty to protect the trust property. If any legal action is necessary the trustee must take it; the beneficiary can only request the trustee to initiate proceedings and if the latter fails to take the required precautions, the beneficiary must proceed thru an equity court to have his rights guarded.

17. *Investments by trustees.*—One of the most difficult problems of the trustee is the handling of his investments. Unless the deed or instrument creating the trust specifically gives the trustee power to continue the investment in the form in which it existed at the creation of the trust, the trustee should immediately convert all the property into funds for legal investment. Reasonable time is allowed and sound discretion must be exercised in selling in the most advantageous manner and at the most advantageous time. Even if the trustee has been given discretion as to investments, he is not justified in investing trust funds in personal securities or in employing them in trade or speculation. Mortgages on real estate are generally considered proper investments for trustees in the United States, but in many

states the subject of investments by trustees is expressly regulated by statute.[1]

If a trustee invests in unauthorized securities the beneficiary may elect to adopt or reject them. If the investment is rejected, the property belongs absolutely to the trustee subject to a lien for the purchase money in favor of the trust estate. If, on the other hand, the trustee invests in authorized securities but does not use due care in purchasing them the property belongs to the trust estate, but the trustee is liable for any loss which may ensue.

A trustee is chargeable with simple interest on balance improperly retained in his hands or deposited to his personal account.

If a trustee is directed by a deed of trust to invest in a particular stock and he neglects to make the investment, the beneficiary may take the money with legal interest thereon or may claim as many shares with their dividends, as the money would have procured if the investment had been made at the proper time. If the trustee uses the trust funds in business, the beneficiary may take either the amount with interest or the profits of the business, but if he chooses the latter he must also share any possible loss. It is a general rule that where a trustee acts prudently in the handling of an estate, any losses rising out of the administration of any part of it may be made good

[1] Several publications have been issued in which the laws of the several states regulating trusteeships have been collected. Bond salesmen are ordinarily instructed by their houses on the possible forms of trust investments permitted in each state.

by the trustee out of the rest of the estate. In brief, this rule means that as long as the trustee acts prudently the trust estate is liable for all losses. Creditors, then, must look to the trust fund and not to the trustee or beneficiary as long as the trustee is properly carrying out the trust.

18. *Compensation of trustees.*—In the United States, trustees are compensated for their trouble in administering the trust estate. In some states, the amount of the compensation is left to the discretion of a court, while in others it is regulated by statute.

19. *The law of trustees' accounts.*—The actions of a trustee are always subject to supervision by an equity court. For that reason a trustee should keep accurate accounts for the trust estate and should be prepared to render an accounting whenever required to do so. It is a cardinal principle of equity that all obscurities and doubtful records in the accounts of trustees are to be taken adversely to the trustee and if, thru failure to keep proper accounts he is unable to specify items, he will be charged with all that he fails to discharge himself of together with such interest as under the circumstances may be equitable and just. A trustee may incur personal liability; he cannot gain any private advantage.

REVIEW

What is the essential difference between the duties of a trustee and those of an executor?

How should an executor keep his accounts?

Is a trustee entitled to make any profit on his trust?

How should the executor provide for the collection of an inheritance tax?

What special books of account would you recommend an executor to keep?

CHAPTER X

INSOLVENCY ACCOUNTS

1. *Insolvency described.*—Up to this time only the accounting practice of solvent business organizations has been considered. It now remains to consider the status of insolvency. A concern may in fact be insolvent when its liquid assets are not sufficient in amount to meet its current liabilities as they mature. This frequently occurs because an undertaking permits too much of its capital to be invested in fixed assets. There may be an excess of assets over liabilities but the current assets may not be sufficient in amount or may not be sufficiently liquid to enable the proprietor to satisfy his maturing liabilities. A business may also suffer losses which will reduce its assets to a sum less than the amount of its liabilities, in which case it will be insolvent even tho the undertaking has all its assets in liquid form.

2. *Voluntary and involuntary bankruptcy.*—If the proprietor realizes clearly that the business is insolvent, either because of his inability to pay his current liabilities out of the current assets, or because the assets, even tho current, are less than the liabilities, he may apply to a court of competent jurisdiction for the appointment of a person to take charge of the business and realize all that he can for the benefit of

the creditors. This proceeding is a voluntary one; the person selected to manage the business or to whom the assets are turned over, is known as the assignee. Where the action against the debtor is taken by creditors who apply to a court for the appointment of a person to take charge of the business, the proceedings are said to be involuntary and the representative of the court who assumes charge is known as the receiver.

3. *The duties of the receiver.*—The assignee or the receiver is an officer of the court and is also a representative of the creditors; it is his duty to collect the assets; to take charge of the liquidation, if such drastic measures are adopted by the creditors, realizing what he can for the benefit of the creditors and paying the excess, if any, to the proprietor.

It is not to be inferred that liquidation follows in all cases; the creditors may permit the assignee or the receiver to manage the undertaking for a period of time sufficiently long to rehabilitate the business. The control of the property will then revert to its owners.

The receiver, upon his appointment, usually employs a competent accountant to make an investigation of the concern's affairs and to render a report to him, showing the actual assets and liabilities of the business. He will then have the assets valued by competent appraisers. After the appraisal and after the creditors have presented their claims, the receiver will be in a position to know just what he may ex-

pect to realize from the assets at forced sale and to what extent the various creditors of the firm will be satisfied. The creditors, upon the receipt of this statement, may then decide whether or not to extend further accommodation or permit the business to be disposed of.

4. *Status of creditors.*—There are four general classes of creditors; first, those holding preferred claims which, by virtue of provisions of the statutes, have a general lien on all the assets. They must be paid before any other creditors are paid; these claims are ordinarily for taxes and labor liens. In a recently decided case the Court of Appeals of the State of New York held that the unpaid salary of a bookkeeper was a preferred claim which the individual stockholders of a company are responsible for, and if only one stockholder is able to pay he shall liquidate the debt. The second class of creditors is known as fully secured creditors, so-called, because the individuals have security for the full amount of their claims. They will realize on the security at the best price obtainable and will return any excess over their claims to the receiver for distribution to the unsecured creditors. The third class is known as partially secured creditors and includes all who have security for part of the amount of their claims and whose duty it is to realize on the security which they hold and satisfy their claims as far as they may be able, from the assets pledged to them. Such persons rank with the unsecured creditors for any portion of

their claims not satisfied. The fourth class, and in the majority of cases the largest both in number and amount, is that class known as unsecured creditors. Persons in this class rank for payment equally in whatever assets the receiver may have left after the first three classes have been satisfied.

5. *Definition of the term "Statement of Affairs."* —The term "statement of affairs" is a technical term used to designate a statement prepared by the accountant for a receiver or assignee showing the assets at their nominal value as well as at their realizable value at forced sale, and the liabilities in the order of their rank.

6. *Relation of balance sheet to statement of affairs.* —Some authors have said that the statement of affairs is an estimated balance sheet. This is an unhappy expression because, after all, a balance sheet is a statement of estimate or opinion and not a statement of fact. It is impossible to tell whether or not the property is stated at its true value in the balance sheet, since no one can say what the amount of the actual depreciation on fixed assets has been. Furthermore, the merchandise on hand as shown by the inventory may not realize the amount at which it is valued in the balance sheet, and the accounts receivable may not all prove collectable. Moreover, the balance sheet simply aims to show financial condition, stating assets at their book value and the liabilities with respect to their status as fixed or current.

The statement of affairs, on the other hand, goes

further than the balance sheet, in that it not only shows the assets at their book value but also the value that they are expected to realize at forced sale, and in addition it shows the liabilities in the order of their rank. Obviously, a balance sheet prepared in the usual manner will not disclose as much information as the statement of affairs. The ordinary balance sheet will not show the status of the different creditors. Thus, if there are $75,000 worth of assets and $100,000 worth of liabilities, a balance sheet prepared in the usual manner will indicate to the creditors on its face that the concern will be able to pay 75 cents on the dollar. But if creditors holding $25,000 in claims have liens on the assets amounting to $25,000, there will remain only $50,000 worth of assets to pay claims amounting to $75,000; therefore, the unsecured creditors may expect to receive, in this instance, only 66 2/3 cents on the dollar. Hence a balance sheet will not disclose facts of vital importance to the partly secured and the unsecured creditors. The statement of affairs presents this important information.

7. *Parties at interest.*—It has been stated by some authors that the statement of affairs is made on behalf of the proprietor or on behalf of the creditors. This is not strictly true because the proprietor will have been displaced either by the assignee or the receiver. The statement is prepared for the purpose of enabling the receiver to make his report to the creditors. The preferred creditors are not particularly interested in the report which the accountant for the

receiver prepares, because there will usually be sufficient assets to satisfy their claims. The statement is rather of interest to the creditors who are partially secured since it enables them to know what loss they may expect to suffer on that portion of their claims which is not secured. It is also interesting to the unsecured creditors because the statement will disclose to them what they may expect to receive out of the assets.

8. *Mechanism of the statement of affairs.*—There is no authoritative method of preparing the statement of affairs but it is desirable, as a rule, to state the assets in the order of their probable realization. Under one form which is commonly employed, three money columns are provided; the first column is headed "book or nominal values"; the second column is headed "expected to realize" and the third column "deficiency." In the column headed "book or nominal values," the values at which the assets are stated on the ledger are shown and it follows that if any reserves for depreciation have been provided for any of the assets, the amount of such reserves will be deducted in stating the value of the assets in the book value column.

Assets which have specific liens against them are stated short; for example, if the book value of the land and buildings, after deducting the reserve for depreciation, was $90,000 and if there was a mortgage on the property, with interest accrued amounting to $86,000, the value stated in the "expected to realize" column will be the equity of the proprietor in

the property, or $4,000. It will thus be seen that the "expected to realize" column will contain the assets or the portion thereof which comes into the receiver's hands free and clear of all claims which the receiver will be able to use for the satisfaction of the claims of the unsecured creditors; a deduction of the amount of the preferred claims, which are a general lien on all of the assets, is made from the total of this column since these claims take precedence over the claims of fully secured creditors. After this deduction has been made, the remainder represents the values which the receiver expects to have at his disposal for the satisfaction of the claims of unsecured creditors.

In stating the liabilities, two columns are provided, the first being headed "book or nominal values" and the second, "expected to rank." The amount shown in the "book or nominal values" column is the amount of the liabilities as shown by the ledger. Since the claims of fully secured creditors have been deducted from the specific assets subject to lien, the amounts of these claims will not be carried into the "expected to rank" column. Since the claims of partially secured creditors have been deducted from the assets which are their security, the amount of the excess of the claims over the anticipated value of the security is carried in the "expected to rank" column. The total amount of the unsecured creditors will of course appear in the "expected to rank" column. The claims of those who hold a preference under the law will not,

of course, appear in the "expected to rank" column since they have been deducted from the aggregate of free assets. The total of the "expected to rank" column contains, therefore, the total of the unsecured creditors' claims against which are offset on the other side the net free and available assets. The net free assets are subject to deduction for the expenses connected with realization and liquidation, the amount of which cannot be foretold. The difference between the total of the unsecured creditors and the total of the free assets, constitutes the deficiency.

It will be obvious that the deficiency stated pertains to debts inasmuch as the statement of affairs is a statement of assets and liabilities only, ignoring the capital. The total deficiency representing the loss not only to the creditors but also to the proprietor is shown by a deficiency account.

9. *The deficiency account.*—It is usual to accompany the statement of affairs with a deficiency account giving details of the deficiency indicated by the statement. The account should start out from the date at which the last balance sheet of the firm showing a solvent condition was prepared. The deficiency account will therefore reveal, on the debit side, the initial loss which may be called the operating loss, since it has resulted in the status of insolvency. The account then states on the debit side the anticipated loss incident to realization and liquidation and, on the credit side, any profit incident to realization and liquidation. The balance of the deficiency account

should then agree with the net deficit as shown by the statement of affairs. It may be pointed out here that the form and manner of arrangement of both the statement of affairs and the deficiency account vary.

10. *Preparation of a statement of affairs for sole proprietorships or partnerships.*—The statement of affairs of a sole proprietor will show as assets not only the assets which he has actively employed in the business, but also all his personal assets. This holds true because in law the business of John Doe, proprietor, is not a separate entity from John Doe himself. In the case of a partnership it must be recalled that the rule of marshalling prevails, and that the personal creditors of the partners must be satisfied out of personal assets and firm creditors out of firm assets and while, as a rule, the partners are individually bankrupt when the firm is bankrupt, this situation may not always prevail and, therefore, any excess from any one of the personal estates of the partners is available for the satisfaction of the claims of the partnership creditors.

11. *Theoretical value of the statement.*—The reader should remember that the statement of affairs is merely an estimate of what a receiver expects or hopes he will be able to do and the original estimate is frequently far from correct. The law does not prescribe the manner in which a receiver shall keep his accounts; of course he will charge himself in his accounting with what he takes over and credit himself

with what he divests himself of; his accounting, like that of a trustee, is an account of charge and discharge. The receiver may continue to use the books of the old undertaking or may open an entirely new set of books; his convenience dictates his method of procedure but in any event the books of account are not adjusted to the facts shown in the statement of affairs. When the assets are realized, the cash account will be debited and the particular assets will be credited, and as payments are made to creditors cash will be credited and the appropriate liability account debited. After all of the assets have been realized in cash, any balance remaining in an asset account represents the loss on realization, and any liabilities remaining unpaid reflect a loss to the creditors. If the business is controlled by a sole proprietor, the accounts remaining open on the books are closed against the proprietor's account. In the case of a partnership, losses are charged against the capital accounts of the partners in the ratio in which they share profits and losses, and if no assets remain available for distribution the loss on realization and liquidation will of course equal the balances remaining in the partners' accounts. In the case of a corporation, the original capital stock account will be debited for the shares returned by the stockholders for cancellation and the remaining accounts will be adjusted thru the surplus account. For the purpose of illustrating the different methods that may be employed in preparing statements of affairs and

deficiency accounts, attention is called to the following problem which has been solved by two different methods:

Jones and Robinson, merchants, are unable to meet their obligations. From their books and the testimony of the insolvent debtors the following statement of their condition is ascertained:

Cash on hand	$5,500.00
Debtors: $1,000.00 good; $600.00 doubtful, but estimated to produce $200.00; $1000.00 bad	2,600.00
Property, estimated to produce $9,000.00	14,000.00
Notes receivable, good	4,250.00
Other securities: $3,000.00 pledged with partially secured creditors; remainder held by fully secured creditors	28,000.00
Jones, drawings	9,000.00
Robinson, drawings	8,400.00
Sundry losses	13,500.00
Trade expenses	7,400.00
Creditors, unsecured	25,000.00
Creditors, partially secured	23,900.00
Creditors, fully secured	17,000.00
Preferential claims, wages, salaries and taxes	700.00
Jones, capital	10,000.00
Robinson, capital	16,050.00

Prepare a statement of affairs, showing the liabilities and the assets with respect to their realization and liquidation; also a deficiency account showing such details as would account for the deficiency shown by the statement of affairs.

The statement of affairs shown on page 166 is arranged to disclose the exact status of the firm on the

JONES & ROBINSON
STATEMENT OF AFFAIRS
December 15, 192–

ASSETS:		NOMINAL VALUE	EXPECTED TO REALIZE	LIABILITIES:		TOTAL LIABILITIES	EXPECTED TO RANK
Cash on hand		$5,500.00	$5,500.00	Creditors, unsecured		$25,000.00	$25,000.00
Property		14,000.00	9,000.00	Creditors, partly secured	$23,900.00	23,900.00	
Sundry Debtors:		2,600.00		Securities at estimated value	3,000.00		20,900.00
Good	$1,000.00			Creditors fully secured	17,000.00	17,000.00	
Doubtful	600.00		1,200.00	Securities at estimated value	25,000.00		
Bad	1,000.00						
				Surplus to contra	$8,000.00		
Notes receivable		4,250.00	4,250.00				
Other securities in the hands of creditors		28,000.00		Preferential creditors, for wages, salaries, taxes, etc.			
Partly secured	$3,000.00			Deduct contra	700.00	700.00	
Fully secured	25,000.00						
Deducted contra	$28,000.00						
Surplus from securities in the hands of creditors, fully secured per contra			8,000.00				
			$27,950.00				
Deduct preferential creditors, for wages, salaries, taxes, etc., per contra			700.00				
			$27,250.00				
Deficiency, as per deficiency account			18,650.00				
		$54,350.00	$45,900.00			$66,600.00	$45,900.00

DEFICIENCY ACCOUNT JONES & ROBINSON

To capital brought into the business at commencement, and since, viz.:			By losses on trading, viz.:		
			Sundry losses	$13,500.00	
			Trade expenses	7,400.00	$20,900.00
Jones, capital	$10,000.00		Losses and shrinkage in values, as exhibited by statement of affairs,		
Robinson, capital	16,050.00	$26,050.00	Property	$ 5,000.00	
Deficiency as shown by statement of affairs		18,650.00	Debtors, doubtful	400.00	
			Debtors, bad	1,000.00	6,400.00
			Drawings from business, viz.:		
			Jones, drawings	$ 9,000.00	
			Robinson, drawings	8,400.00	17,400.00
		$44,700.00			$44,700.00

JONES & ROBINSON

Statement of Affairs
December 15, 192–
Second Method

Assets		Nominal Value	Expected to Realize	Deficiency
Cash on hand		$ 5,500.00	$ 5,500.00	
Sundry debtors:		2,600.00	1,200.00	$ 1,400.00
Good	$ 1,000.00			
Doubtful	600.00			
Bad	1,000.00			
Notes receivable		4,250.00	4,250.00	
Other securities in the hands of creditors:		28,000.00		
Partly secured	3,000.00			
Fully secured	25,000.00			
Deducted per contra	$28,000.00			
Surplus from securities in the hands of creditors, fully secured, per contra			8,000.00	20,000.00
Property		14,000.00	9,000.00	5,000.00
			$27,950.00	
Deduct preferential creditors for wages, salaries taxes, etc., per contra..........			700.00	
Net free assets, available for settlements of claims of unsecured creditors being 59.36% of their claims...			27,250.00	
Deficiency			18,650.00	
Impairment of partners' capital		12,250.00		
		$66,600.00	$45,900.00	$26,400.00

Liabilities		Nominal Value	Expected to Rank
Creditors unsecured		$25,000.00	$25,000.00
Creditors, partly secured.....	$23,900.00	23,900.00	
Securities at estimated value per contra	3,000.00		20,900.00

Liabilities		Nominal Value	Expected to Rank
Creditors fully secured	$17,000.00	$17,000.00	
Securities at estimated value per contra	25,000.00		
Surplus to contra	$ 8,000.00		
Preferential creditors for wages, salaries, taxes, etc.			
Deducted, per contra		700.00	
		$66,600.00	$45,900.00

Deficiency Account

To losses on trading, viz:			By capital brought into the business at commencement, and since, viz.:		
Sundry Losses	$13,500.00		Jones, capital	$10,000.00	
Trade expenses	7,400,00	$20,900.00	Robinson, capital	16,050.00	$26,050.00
Losses and shrinkage in values, as exhibited by statement of affairs, viz.:			Deficiency as shown by statement of affairs		18,650.00
Property	$ 5,000.00				
Debtors, doubtful	400.00				
Debtors, bad.	1,000.00	6,400.00			
Drawings from business, viz.:					
Jones	$ 9.000.00				
Robinson	8,400.00	17,400.00			
		$44,700.00			$44,700.00

date of December 15. The left-hand side of the statement shows in one column the nominal or book value of the assets. The second column shows the amount that we expect these assets to realize. Creditors are not much interested in the book value of the assets, but they are interested to know how much they may expect to realize from these assets. The total of this column after deducting preferential claims is $27,250. On the right-hand side of the statement are shown the

liabilities. We have there also two columns, one showing the total or book liabilities and the other the amount the liabilities are expected to rank. It will be noticed that the secured creditors are omitted entirely, since they are not expected to rank to any amount as they are fully secured.

The partially secured creditors are shown in the total liabilities column for the full amount, while in the column "expected to rank" only $20,900 as the securities in their possession as part pledge are estimated at $3,000. Preferential claims are entered only in the total liability column because they have been deducted from the total assets. The total of the column "expected to rank" amounts to $45,900. As the assets available for distribution amount to only $27,250, we have a deficiency of $18,650, which is accounted for and explained in the deficiency account shown on page 167.

This account begins on the debit side with the capital brought into the business at commencement, amounting to $26,050. On the credit side are entered the losses on trading, as well as the trading expenses, making the total $20,900. The second part on the same side deals with the losses and shrinkages in values which amount to $6,400. Finally are entered the withdrawals amounting to $17,400, thus showing a total on the credit side amounting to $44,700. Against this is the capital only, amounting to $26,050, hence there is a deficiency amounting to $18,650, which is the exact sum shown on the statement of affairs.

12. *Realization and liquidation account.*—The statement of affairs sets forth what the receiver may expect to accomplish on the basis of forced liquidation. If, after the receiver's report has been submitted, the creditors decide to wind up the affairs of the insolvent business, the receiver realizes on the assets and pays out the claims against the insolvent estate in the order of their rank. He disposes of the assets, debiting his cash account for the amount received on realization and crediting the individual asset accounts. As claims are paid off, the appropriate liability accounts are debited and cash account is credited. After all the assets have been sold and the proceeds applied in the liquidation of the liabilities, the accounts remaining open on the ledger will be the balances in the asset accounts, representing the excess or deficit of book value on realization, and the unliquidated liabilities and the capital accounts of the proprietor or partners, or the capital stock and surplus accounts of a corporation.

The losses on winding up should be charged to the capital account of a sole proprietor or to the capital accounts of partners in a partnership; in corporations, the losses will be charged against surplus. The stockholders in a corporation will surrender their shares of capital stock, which will be debited to capital account and credited to surplus. If the realization is conducted at a loss, the amount of unliquidated liabilities will of course equal the debit balance in the capital account of a sole trader or the debit balances

in the accounts of partners; in a corporation, the debit balance in the surplus account will be equal to the amount of the unliquidated liabilities.

Should the receiver be fortunate enough to conduct the realization so as to obtain a surplus over the book value of the assets at the time of sale, such excess will be credited to the surplus or individual capital accounts. Very often the receiver will open up a "winding-up" account thru which the closing operations will be entered.

13. *Form of realization and liquidation account.*—The form of realization and liquidation account used by teachers of accounting and employed in C. P. A. examinations is not a practical statement. It is made up in either account or statement form. If the account form is used, the realization and liquidation account is debited with the assets to be realized and credited with the liabilities to be liquidated. Cash on hand is not included in the assets to be realized because cash is already realized. The statement is then credited with the assets realized and debited with the liabilities liquidated. Any expenses of the receiver in connection with realization and liquidation are debited to the account under the caption "supplementary debits"; any income collected by the receiver after he takes charge is credited to the account under the caption "supplementary credits." At the date of the accounting, the assets not realized are credited to the account and the liabilities not liquidated are debited to the account. The difference between the debit

and credit sides of the account will then represent the profit or loss to date on realization and liquidation. This account will not, however, show the details of the profit or loss on realization and it is customary to supply a realization profit-and-loss account showing the details; this statement may of course be reconciled with the profit or loss shown in the realization and liquidation account.

The cash transactions of the receiver are shown in a separate cash account because he is usually paid on the basis of the cash received and paid out. The receiver's cash account will start with the balance on hand at the time he took charge; it will be debited with the proceeds of the assets realized and with any income received by him during realization; it will be credited with the liabilities liquidated and with any expenses paid during realization. The balance of the two sides of the account may be reconciled with the cash in the hands of the receiver. If the liquidation has not been completed at the date of the accounting, it is customary to prepare a receiver's balance sheet which will show the cash and other assets on hand at the date of the accounting; the liabilities unliquidated will be stated and the difference between the two sides will represent the profit or loss on realization and liquidation to the date of the accounting, assuming that the remaining assets will be liquidated at the values shown in the books of the undertaking.

For the purpose of illustrating the preparation of the realization and liquidation account, attention

is called to the following problem and solution:

PROBLEM [1]

The affairs of Peter Post, a manufacturer, were in a critical condition, for altho he had an unimpaired investment of $62,500, and his books showed a clear increase of $6,022, he owed his trade creditors $25,289 and had only $265 in cash and $4,062 in receivable book accounts on which to rely for funds. The rest of his business estate was tied up in the following chattels which he had acquired in an effort to keep pace with the business growth that had outrun his capital: machinery and tools, $31,497; raw materials, $18,838; partly made goods, $31,562, and finished wares, $7,587. It was also necessary in order to continue operations to have immediate cash for payrolls and incidental expenses.

A meeting of his principal creditors was called and as it appeared that the business was well established, profitable and had a sure and growing market, they decided to advance him $6,000 in cash for immediate needs and extend his credit in sufficient amount to permit of the purchase of necessary materials and generally to continue operations till the present stock of materials could be made up and realized on.

In order to insure the proper application of the funds and credit so provided, a trustee was appointed to administer the finances till the creditors' claims were satisfied, at which time the control would revert to the proprietor.

The subsequent operations under the trusteeship were as follows: cash paid for labor $15,725; for expenses $5,430; for additional tools $750; purchases on book account, charged to materials $6,300; to expenses $15,000; sales on book account $72,300; loss on collection of book debts $380; personal drawing of Peter Post $3,500.

The unliquidated values at the close of the trusteeship were as follows: inventory of raw materials $5,000; finished wares $27,900; accounts receivable outstanding $3,382; accounts payable $89.

Prepare with due regard to the grouping, order, and ar-

[1] New York C. P. A. Examination.

rangement of the items, as best calculated clearly to display the facts, (a) realization and liquidation account, (b) trustee's cash account, (c) balance sheet of business as restored to Peter Post.

BALANCE SHEET OF PETER POST (WHEN TURNED OVER TO TRUSTEES)

Assets		*Liabilities*		
Cash	$ 265	Creditors		$25,289
Accts. receivable	4,062	*Proprietorship*		
Mchy. & tools	31,497	Capital	$62,500	
Raw materials	18,838	Surplus	6,022	68,522
Goods in process	31,562			
Finished goods	7,587			
	$93,811			$93,811

REALIZATION AND LIQUIDATION ACCOUNT OF PETER POST

Assets to be realized			*Liabilities to be liquidated*		
Accts. receiv.	$ 4,062		Creditors	$25,289	
Mchy. & tools	31,497		Creditors (loan)	6,000	$31,289
Raw material	18,838				
Goods in process	31,562				
Finished goods	7,587	$93,546			
Liabilities liquidated			*Assets realized*		
Creditors		31,200	Accts. receiv.	$ 680	
Liabilities not liquidated			Raw material	13,838	
Creditors		89	Goods in process	31,562	46,080
Supplementary charges			*Assets not realized*		
Inventory	$13,838		Accts. receiv.	$ 3,382	
"	31,562		Raw material	5,000	
Purchases	6,300		Finished goods	7,587	
Labor	15,725		Mchy. & tools	31,497	47,466
Expenses	5,430		*Supplementary credits*		
Tools	750		Finished goods	$20,313	
Expenses	15,000	88,605	Sales $72,300		
Profit on operation		3,628	Less loss 380	71,920	92,233
		$217,068			$217,068

TRUSTEE'S CASH ACCOUNT

Balance	$ 265	Labor	$15,725
Loan from creditors	6,000	Expenses	5,430
Sales	71,920	Tools	750
Accts. receivable	680	Materials	6,300
		Drawings	3,500
		Expenses	15,000
		Accts. payable	25,200
		Creditors' loan	6,000
		Balance	960
	$78,865		$78,865
Balance	$ 960		

BALANCE SHEET OF PETER POST (AFTER REALIZATION AND LIQUIDATION)

Assets		*Liabilities*		
Cash	$ 960	Creditors		$ 89
		Proprietorship		
Accts. receivable	3,382	Capital at beginning	$62,500	
Raw material	5,000	Surplus at beginning	6,022	
Finished goods	27,900		68,522	
Mchy. & tools	31,497	Less drawings	3,500	
			65,022	
		Add profit	3,628	68,650
	$68,739			$68,739

REVIEW

How would you differentiate between voluntary and involuntary insolvency?

How would you define the term, "statement of affairs"? What information will a statement of affairs disclose that would not be disclosed by an ordinary balance sheet?

What is the relation between the deficiency account and the statement of affairs? Can you trace the analogy between the balance sheet and statement of affairs and between the profit-and-loss account and the deficiency account?

How should reserves for depreciation be treated in the preparation of a statement of affairs?

CHAPTER XI

CORPORATIONS

1. *The varied aspect of corporations.*—In different volumes of the Modern Business Text, corporations are treated from different standpoints. In "Business Organization," the legal phases of corporations are considered. In "Corporation Finance" the topic is the procedure followed in securing the capital for the enterprise. Here it is the purpose to deal particularly with the accounting of corporations, tho it is in practice sometimes difficult to draw distinct lines of demarcation between law, finance and accounting in the discussion of corporate problems.

2. *Difference between accounting practice of corporations and that of partnerships.*—There is no difference in the general scheme of accounts in a corporation from that employed in a partnership, except as to the opening and closing entries, the booking of the proprietorship and the distribution of profits. A corporation is required to keep certain incidental books which differ from the records of partnerships.

3. *Books incidental to a corporation.*—Most if not all of the following auxiliary books are necessary if proper records are to be kept of transactions of a corporation:

(a) Minute book,
(b) Subscription book,
(c) Instalment book,
(d) Instalment-scrip book,
(e) Stock-certificate book,
(f) Stock ledger,
(g) Stock-transfer book,
(h) Dividend book.

4. *Minute book.*—The minute book contains a record of all the meetings of the stockholders, and generally of all the meetings of the board of directors, altho in some cases it is advisable to have a separate minute book for the meetings of the directors. In certain corporations where some of the duties of the directors are delegated to an executive committee, there will be a separate minute book for the meetings of the executive committee.

5. *Subscription book.*—The subscription book is used for the purpose of recording the subscriptions of stockholders. It should contain the date of each subscription, the name and the address of the subscriber and the number of shares which he agrees to take. This book records the contract existing with the subscribers, whereby each binds himself to take the amount of stock for which he has subscribed. If the corporation is small, or if it is a close corporation, the account of subscriptions is commonly kept in the general ledger.

STOCK LEDGER

NAME .... ADDRESS ....

DATE OF TRANSFER OF SHARES BY THE ABOVE-NAMED	TRANSFER NO.	TO WHOM SHARES ARE TRANSFERED	LEDGER FOLIO	CERTIFICATES SURRENDERED		DATE OF ACQUISITION OF SHARES	FROM WHOM SHARES WERE TRANSFERRED (IF ORIGINAL ISSUE ENTER AS SUCH)	LEDGER FOLIO	CERTIFICATES ISSUED		BALANCE REMAINING CR. OF ABOVE
				CERTIF. NOS.	NO. SHARES				CERTIF. NOS.	NO. SHARES	

STOCK TRANSFER BOOK

WE, the persons named below, recorded owners of the Capital Stock of represented by the certificate described below, do by the undersigned Attorney, hereby sell, assign and transfer the number of Shares of said stock set opposite our respective names, to the persons indicated:

DATE	CERTIFICATES SURRENDERED		FROM WHOM TRANSFERRED	LEDGER FOLIO	CERTIFICATES ISSUED		TO WHOM TRANSFERRED	LEDGER FOLIO	ADDRESS	SIGNATURE OF ATTORNEY
	NOS.	SHARES			NOS.	SHARES				

INSTALMENT LEDGER

JAMES SMITH, 320 BROADWAY, NEW YORK, N.Y.

DATE	SHARES	HOW ACQUIRED	% UNPAID	CERTIFICATE NO. OF SCRIP	AMOUNT	DATE	SHARES TRANS-FERRED	HOW SETTLED	% UNPAID	CERTIFICATE NO. OF SCRIP	ON HOW MANY SHARES PAID	INSTAL-MENT	%	AMOUNT
1916						1916								
Jan. 15	100	Subscribed	100		$10,000.00	Feb. 1		Paid		1	100	1	25	$2,500.00
Mch. 1	50	F. Brown	75	25	3,750.00	Mch. 15	50	Surrendered	75	25				3,750.00
Mch. 15	25	Reissued	75	26	1,875.00	Mch. 15	25	A. Peters	75	26				1,875.00
Mch. 15	25	Reissued	75	27	1,875.00	April 15		Paid		50	125	2	25	3,125.00

STOCKHOLDERS' LEDGER

A.B. NICHOLS, 480 WEST BROADWAY, NEW YORK, N.Y.

DATE	SHARES	HOW DISPOSED	CERTIFICATE NO.	AMOUNT	DATE	SHARES	HOW ACQUIRED	CERTIFICATE NO.	AMOUNT
1916					1916				
Feb. 25	200	M. Alexander	10	$20,000.00	Jan. 20	500	Original issue	1	$100,000.00
Mch. 10	300	Surrendered	50	30,000.00	Feb. 1	200	J. Smith	10	20,000.00
					Mch. 1	300	F. Brown	50	30,000.00
					Mch. 12	100	Reissued	75	10,000.00
					Mch. 12	200	Reissued	76	20,000.00

6. *Instalment book.*—The instalment book is made up from the records of the subscription book and contains the name of each subscriber and the amount of each instalment paid. A separate record should be kept for each instalment. It is hardly necessary to state that the use of the instalment book and of the instalment-scrip book is limited to cases where the stock is to be paid for by instalment.

7. *Instalment-scrip book.*—The instalment-scrip book is the receipt book for instalments paid by stockholders. It contains blank receipts to be filled out and signed by the secretary and the treasurer as the instalments are paid; the receipts are given to the subscriber by the secretary. In some cases the by-laws of a corporation provide that the president and the secretary, instead of the treasurer and the secretary, shall sign these receipts. Upon the payment of the last instalment, the scrip should be taken up and a certificate of stock should be issued in its place.

8. *Stock-certificate book.*—The "stock-certificate" book, or simply the "certificate" book, contains blank certificates to be filled out and signed, in accordance with the provisions of the by-laws of the corporation, either by the secretary, the president and treasurer, or by the secretary and the treasurer. For convenience, these certificates are numbered consecutively. A transfer form is usually printed on the back of the certificate, in order to facilitate the transfer or sale of the stock.

9. *Stock ledger.*—The stock ledger contains an ac-

count entitled "capital stock," which is debited with the par value of all the stock issued. It also contains an account for each stockholder, which is credited with the par value of the stock issued to him. When stock is transferred, for any reason, from one owner to another, the transferer is debited, and the transferee is credited, with the par value of the stock transferred. Thus this ledger is always self-balancing, and the account for capital stock is exactly the reverse of the capital-stock account in the general ledger, which is credited with the par value of the stock issued, to record the liability of the corporation thereon. Furthermore, this ledger shows the detail of the capital-stock account in the general ledger. In those cases in which it is customary to place upon the general books of the corporation the total amount of the authorized issue of stock, as a ledger account, offsetting it by the total amount unissued, the difference at any time between the capital-stock-authorized account and the balance remaining in the capital-stock-unissued account will be the amount of the capital-stock issued. This latter amount, of course, should equal the amount shown in the capital-stock account in the stock ledger, and should agree with the data that is given on detailed list of stockholders, as shown by the stock ledger.

The laws of the State of New York call for the keeping of a stock book or a stock ledger which shall contain the following information: (1) the names of stockholders, arranged alphabetically; (2) the resi-

dence of each stockholder; (3) the number of shares held by each; (4) the time when stock was acquired; (5) the amount paid thereon; (6) a record of all transfers, showing from whom the stock was received and to whom it was transferred.

10. *Stock-transfer book.*—The stock-transfer book is used for the purpose of recording the transfers of stock, and contains the original entries which are posted to the stock ledger. In some cases the stock ledger and the stock-transfer book are combined. But both books, separate or combined, are required by the laws of a number of states. In New York state there is a tax on the transfer of capital stock, and the law requires a special form of book to be kept by transfer agents and brokers. There is no transfer tax on the original issue of capital stock, but all transfers of a beneficial interest are taxable.

11. *Dividend book.*—The dividend book, or more properly, the dividend-receipt book, is used for the purpose of recording each dividend declared and paid. It contains a record of each dividend, of the number of shares held by each stockholder, and of the amount of the dividend paid thereon, with the signature of the stockholder as a receipt for the dividend paid to him.

12. *Illustration of stock-transfer book.*—The form given on page 179 is an illustration of a stock-transfer book. The left side of the page records the transfer of the stock, and the right side attests its validity. The number of shares surrendered and the number

of shares each certificate represents, are entered; the name of the person from whom they have been transferred and, for convenience, the folio of his account in the stock ledger, are also shown. The number of the new certificate, the number of shares it represents, the name of the person to whom it is transferred, i.e., the transferee; the address of the transferee; and for convenience, the folio of his account in the stock ledger, are given, and to close the page, the signature of the stockholder's attorney, authorized to make the transfer, who is the secretary of the corporation.

13. *Illustration of stock ledger.*—The form given on page 179 illustrates a stock ledger. It shows the name and address of a stockholder, the date when any transfer or surrender of stock was made, the number of the transfer and the person to whom the transfer was made. It also shows the number of the certificate surrendered and the number of shares it represents. On the right-hand side of the account are the date of acquisition of stock and the information whether it is an original issue or a transfer from a prior holder. If the latter, the name of that prior holder is recorded. Columns are provided for the number of the new certificate issued and the number of shares it represents. The balance of shares held at any time is shown in the last column. As stated on page 181, the stock is often sold with the understanding that it is to be paid for in instalments; the instalment book and the instalment-scrip book are used in such a case. It is sometimes advisable to use

an instalment ledger also, in order to keep track of the various payments. On page 180 an illustration of an instalment ledger is given. In this example, it will be noted that the original subscription was made on January 15th. On that date James Smith subscribed to 100 shares at $100 each, a total of $10,000 on which he paid nothing. On February 1st, he paid the first instalment of 25 per cent; his account in the instalment ledger was credited for that payment, and instalment scrip for that amount was issued to him.

On March 1st, F. Brown transferred to Smith his subscription to 50 shares of stock, on which the first instalment had already been paid. Smith's account is therefore charged for that transfer, and shows the unpaid amount of $3,750. On March 15th, Smith transferred 25 shares to A. Peters. In order to complete that transfer, Smith surrendered the instalment scrip for 50 shares issued to him on Brown's transfer, and was given two new scrips, each for 25 shares, in order that he might be able to give to Peters the scrip that he than transferred. On April 15th, Smith paid the second instalment on his subscriptions, and this was credited to his account.

If the shares debited on the left side of the account are added, and the shares credited on the right side subtracted from them, the number of shares on which there remains an unpaid balance will be found. Smith's subscriptions at present are 125 shares, on which two instalments have already been paid. A comparison of the total debits with the total credits

in the monetary columns shows a debit balance of $6,250, which Smith still owes. That balance represents the two instalments that he owes on the 125 shares which he at present owns.

14. *More than one form of stock ledger possible.*—The reader has already been given on page 179 an illustration of a stock ledger. This is not by any means the only form of stock ledger commonly used. Special forms are adopted for use in particular cases. Sometimes a combination of the stock-transfer book and the stock ledger is used, and sometimes a combination of the instalment ledger and the stockholders' ledger. On page 180 there is an illustration of a common form of stockholders' ledger. The credit or right side of each account shows the total amount of stock issued to the stockholders that they have received. This credit may represent original issues or subsequent acquisitions of stock. The debit side shows any surrender to the corporation or transfer to others of the stock which he owns. The difference between the total of the credit-column "shares" and the total of the debit-column "shares," represents the number of shares owned by the stockholder; and the difference between the corresponding money columns is the par value of those shares. If the latter figures cannot be obtained by multiplying the par of the stock by the number of shares shown by the former figure, there has been an error in the keeping of the books.

Sometimes stock without any par value is issued,

but no new complications are involved in such a case. It is evident, of course, that the records should show the value of the property received in exchange for the specified number of shares. In all cases the record should show just what the stock was issued for. In a close corporation, stockholders' accounts are sometimes carried on the general ledger, but this is rather unusual.

15. *Opening entries for corporate books; first illustration.*—There are a number of different ways in which corporate books may be opened. For the purpose of illustration, let it be assumed that The Prosperous Company was incorporated on January 1, 1920, with an authorized capital of $1,000,000, of which $500,000 was preferred stock and $500,000 was common stock, par value $100 a share. The incorporators subscribed and paid for $50,000 of the common stock, and $100,000 of preferred stock was sold to the public.

The first method starts with a statement of the incorporation and the capitalization of the company; in addition, it provides a record of the contractual agreement entered into between the subscribers and the corporation, whereby the former agreed to take a certain amount of the stock.

THE PROSPEROUS COMPANY
Incorporated under the laws of the State of New York
with an
AUTHORIZED CAPITAL
of
$1,000,000

Divided into 5,000 shares of preferred stock and
5,000 shares of common stock
Par value $100 each

Subscribers	$50,000	
To Subscription		$50,000
for the subscriptions of the incorporators who have agreed to take 500 shares of the common stock.		
Cash	50,000	
To Subscribers		50,000
payment of the subscriptions by the incorporators.		
Subscriptions	50,000	
To Common capital stock		50,000
for 500 shares of common stock issued to incorporators.		
Cash	100,000	
To Preferred capital stock		100,000
for the sale of 1,000 shares of preferred stock to sundry purchasers.		

16. *Opening entries for corporate books; second illustration.*—According to the second method of opening corporate books, the total authorized issue of stock is placed on the books in the form of a ledger account; it will be noted that this method differs from the method illustrated above in this particular respect. The full authorized stock is offset by an account with the unissued stock. Under this method, the amount of stock issued and outstanding at any time will be the difference between the amount standing at the credit of the authorized-stock account, minus the amount standing at the debit of the unissued account. The unissued stock, while it is a debit on the ledger, is not an asset; in the preparation of

the balance sheet of the organization, the amount of stock unissued should be deducted from the authorized amount on the liability side of the balance sheet.

Common capital stock unissued	$500,000	
Preferred capital stock unissued.......	500,000	
To Common capital stock, authorized		$500,000
Preferred capital stock, authorized.		500,000
To record the incorporation of the Prosperous Company organized under the laws of the State of New York, with an authorized issue of 5,000 shares of common and 5,000 shares of preferred stock, par value $100 each.		
Subscribers to common capital stock....	$50,000	
To subscriptions to common capital stock		50,000
To record the subscriptions of the incorporators for 500 shares of common stock.		
Cash	50,000	
To Subscribers to common capital stock		50,000
For the payment by the latter of their subscriptions to the common stock.		
Subscriptions to common capital stock..	50,000	
To Common capital stock unissued.		50,000
For the issue of 500 shares of common stock to the abovementioned subscribers.		
Cash	100,000	
To Preferred capital stock unissued		100,000
To record the sale of 1,000 shares of the preferred stock for cash.		

17. *Third illustration.*—Instead of either of the above two methods, the following method of opening entry might have been used:

Unsubscribed common stock	$450,000	
Subscribed common stock	50,000	
To Common capital stock authorized		$500,000
Unsubscribed preferred stock.........	500,000	
To Preferred capital stock authorized		500,000
Cash	100,000	
To Unsubscribed preferred stock.. To record the sale of 1,000 shares of preferred stock for sale.		100,000

REVIEW

The same subject is continued in the following chapter. Review questions covering both chapters will be found on page 207.

CHAPTER XII

CORPORATIONS (Concluded)

1. *Other illustrations of opening entries.*—The following problems illustrate a number of phases of corporate opening entries, as well as the procedure to be followed in converting a partnership to the corporate form of organization.

PROBLEM

John Smith, Alfred Brown, Peter Marks and Adam Freund decide to incorporate under the laws of the State of Illinois as The Brown Manufacturing Company. They agree that the capital stock of the company is to be $25,000, divided into 1,000 shares at the par value of $25 each. The subscription to such stock is as follows: J. Smith, 200 shares; Alfred Brown, 300; Peter Marks, 250, and Adam Freund, 250.

They duly sign a subscription agreement and, after the articles of incorporation are approved by the secretary of state, each pays one-half of his subscription in cash and gives a note payable in sixty days for the balance.[1] The organization expenses in con-

[1] The payment of stock subscriptions by notes is a frequent practise tho not to be commended. See Corporation Finance, p. 51.

nection with the formation of the corporation amount to $350.

Required: (a) the entries in the various corporation books; (b) the initial balance sheet.

SOLUTION

The initial entry should be a memorandum to show the organization of the corporation, in form such as this:

THE BROWN MANUFACTURING COMPANY
Incorporated under the Laws of the
State of New York, with an
Authorized Capital
of
$25,000
divided into One Thousand Shares of $25 each.

This entry would, of course, be made in the journal of the corporation.

The subscriptions to the stock should appear in the subscription book. The following entry is then made:

Subscription Account	$25,000	
To Capital stock		$25,000
Representing the subscriptions to the Capital stock of the company, viz:		
J. Smith 200 shares		
A. Brown 300 "		
P. Marks 250 "		
A. Freund 250 "		

As one-half of the subscription is paid in cash an entry should be made in the cash book, on the debit side, shown on page 193.

Attention is called to the fact that, while in this form of cash book only one monetary column is shown, recording only this particular transaction, the usual form of cash book contains more than one monetary column.

Dr. CASH BOOK.... 191....

(Date)	To subscription account J. Smith	50% on stock subscribed	$2,500.00
(Date)	To subscription account A. Brown	50% on stock subscribed	3,750.00
(Date)	To subscription account P. Marks	50% on stock subscribed	3,125.00
(Date)	To subscription account A. Freund	50% on stock subscribed	3,125.00

As the subscribers pay the other 50 per cent of their subscriptions by notes the following entry in the journal is made:

Notes receivable	$12,500	
To Subscription account		$12,500
Representing four 60-day notes, given by Smith, Brown, Marks and Freund respectively, in payment for 50% of their subscriptions.		

The organization expenses in connection with the formation of the company, amounting to $350, are shown on the credit side of the cash book, as follows:

CASH BOOK Cr.

Date	Organization expenses	Expenses incurred in connection with the organization of the company..	$350.00

In the entries in the books of the company, those pertaining to the issue of the stock are omitted, because in a former chapter the method of entering the issue of stock in the stock ledger has been given.

The initial balance sheet of the corporation is as follows:

Balance Sheet of the Brown Manufacturing Company as on 192–

Assets:			*Capital Stock.*
Cash $12,150.00			Capital stock.$25,000.00
Notes receivable	12,500.00	$24,650.00	
Organization expenses		350.00	
		$25,000.00	$25,000.00

This balance sheet shows the cash on hand to be $12,150. It will be recalled that $12,500 in cash was received from the subscribers, from which organization expenses of $350 were paid, leaving the balance as shown above. The notes receivable are the notes given by the subscribers in payment for the second half of their subscriptions. These two items represent the available assets of the company, and accordingly they are grouped together. The item for organization expenses is treated for the present as an asset for the reason that it will be met out of the profits that the company expects to earn during the year. As it is not an asset that can be converted into cash at present, it is entered separately from the other assets. The credit side of the balance sheet does not contain any liabilities because none have been incurred.

2. *Procedure when a partnership is converted into*

a corporation.—The following problem will illustrate the conversion of an existing partnership into a corporation:

PROBLEM

A, B and C constitute a firm engaged in a manufacturing business which they have decided to incorporate with a capital stock of $100,000, equally divided into common and preferred stock, the par value of each share to be $100.

The agreement among the partners is that each partner is to take 75 per cent preferred and 25 per cent common stock to the amount of his net investment in the business. The remaining shares authorized are to be offered for sale.

The partnership books show the following balances in the ledger accounts:

Real estate	$25,000.00
Accounts payable	5,000.00
Accounts receivable	9,000.00
Cash	5,000.00
Machinery and tools	10,000.00
Merchandise	15,000.00
Notes receivable	3,000.00
Notes payable	10,000.00
Materials and supplies	8,000.00

The capital of the partners consists of $60,000 divided as follows: A, five-twelfths; B, four-twelfths; C, three-twelfths.

Required: (a) closing entries for the partnership books; (b) opening entries for the corporation books.

BALANCE SHEET OF THE FIRM A, B & C.

ASSETS:			
Cash		$ 5,000.00	
Notes receivable	$3,000.00		
Accounts receivable ..	9,000.00	12,000.00	
Merchandise inventory		15,000.00	
Materials and supplies		8,000.00	$40,000.00
Real estate		25,000.00	
Machinery and tools..		10,000.00	35,000.00
			$75,000.00

LIABILITIES:		
Notes payable	$10,000.00	
Accounts payable	5,000.00	$15,000.00
PROPRIETORSHIP:		
A's Capital Account............	$25,000.00	
B's Capital Account............	20,000.00	
C's Capital Account............	15,000.00	60,000.00
		$75,000.00

SOLUTION

Before we can proceed to make any entries we must arrange the facts given in the problem in some systematic order. As there are no nominal accounts, we can prepare the balance sheet shown on the preceding page.

As far as the partners are concerned there is no material change, since they will share in the dividends of the firm on the same basis that they have shared in the profits of the partnership, each partner receiving stock to the amount of his capital in the partnership. In law, however, the A B C Manufacturing Co. is entirely different from the former firm of A, B & C, altho owned and controlled by the same persons. It is assumed that the old firm, A, B & C, sells to the A B C Manufacturing Co. all its assets, and that the company assumes to pay all the liabilities of the old firm. The consideration to be paid by the company for this purchase would be the value of the assets less the liabilities, or the amount of the proprietorship in the partnership. This will be done by the issue of stock. The first entry, then, in the books of the firm A, B & C will be in the journal as follows:

The A B C Manufacturing Co.	$75,000.00	
To Cash		$5,000.00
Notes receivable		3,000.00
Accounts receivable		9,000.00
Merchandise		15,000.00
Materials and supplies ..		8,000.00
Machinery and tools		10,000.00

Real estate		$25,000.00
For the sale of all the assets enumerated above.		

This entry records the sale of the assets which creates a debit or charge against the A B C Manufacturing Co. and a credit to respective asset accounts. It is obvious that when this entry is posted the various asset accounts will be closed out in the partnership books.

The next entry, also made in the journal, will show the assumption of the liabilities of the old firm by the corporation, and will be as follows:

Notes payable	$10,000.00	
Accounts payable	5,000.00	
To A B C Manufacturing Co.		$15,000.00
For the assumption of the above mentioned liabilities, by the vendee, the A B C Manufacturing Co.		

Thus far the A B C Manufacturing Co. has been charged with the assets acquired, amounting to $75,000 and credited with the liabilities assumed, amounting to $15,000. By this second entry the liability accounts have been closed out in the books of A, B & C. The A B C Manufacturing Co.'s account shows a debit balance of $60,000 due to the partnership. In accordance with the agreement the corporation is to issue to the partnership 75 per cent of this amount in preferred stock and 25 per cent of it in common

stock. When this has been done, the following entry is made in the partnership journal:

Preferred capital stock......	$45,000.00	
Common capital stock........	15,000.00	
To the A B C Manufacturing Co.		$60,000.00
This represents the issue of stock, it being the balance of the purchase price of all the assets after the assumption of the liabilities.		

As this stock is to be apportioned to the respective members of the firm in accordance with their investment accounts, the following entry in the partnership journal is made:

A's capital account..........	$25,000.00	
To Preferred capital stock..		$18,750.00
Common capital stock....		6,250.00
For his share in the net capital of the partnership.		
B's capital account..........	20,000.00	
To Preferred capital stock..		15,000.00
Common capital stock....		5,000.00
For his share in the net capital of the partnership.		
C's capital account..........	15,000.00	
To Preferred capital stock..		11,250.00
Common capital stock....		3,750.00
For his share in the net capital of the partnership.		

This last entry closes all the accounts that have appeared on the books of the partnership, because the firm has sold its assets, its liabilities have been assumed by another concern, and the partners have received stock for their investments.

This completes the first part of the problem, namely, the closing of the books of the partnership.

3. *How entries are opened in books of a corporation.*—The second part of this problem deals with the opening entries in the corporation books. The first entry will be a memorandum in the journal, showing the organization of the company, as follows:

THE A B C MANUFACTURING CO.
Incorporated under the laws of the
State of ...... with an
Authorized Capital
of
$100,000.00
Divided into $50,000.00 Common and
$50,000.00 Preferred stock
of One Hundred Dollars par value each.

The next entry should also be in the journal to show the subscription to the capital stock as follows:

Subscription to preferred capital stock	$45,000.00	
Unsubscribed preferred capital stock	5,000.00	
Subscribed common capital stock	15,000.00	
Unsubscribed common capital stock	35,000.00	
To Authorized preferred capital stock		$50,000.00
Authorized common capital stock		50,000.00
For the capital stock subscribed as follows:		

A 250 shares, common and preferred.
B 200 shares, common and preferred.
C 150 shares, common and preferred.

It will be noticed that in the first problem the entire amount of authorized capital stock was subscribed to, while in this problem only part of it is so taken. As it is advisable to show in the capital stock account the full amount of capital stock authorized, an account "unsubscribed capital stock" is debited for the amount that is unsubscribed, in order to justify the placing of the full authorized issue of stock on the books. But in preparing a financial statement it is not advisable to list this unsubscribed stock on the debit side, because it is not in any sense an asset. This account should be deducted from the capital stock which should be stated in the balance sheet thus:

Authorized preferred capital stock	$50,000.00	
Less unsubscribed	5,000.00	$45,000.00
Authorized common capital stock	50,000.00	
Less unsubscribed	35,000.00	15,000.00

The next journal entry should show the acquisition of the various assets as follows:

Plant and sundry assets	$70,000.00	
Cash (also entered in the cash book)	5,000.00	
To A, B and C		$75,000.00
For the transfer to this com-		

pany by the above mentioned vendors of their right, title and interest in all of their assets, including cash, as scheduled in the bill of sale, dated ....191..

As the company has assumed the liabilities of the firm, the following entry is made in the journal:

A, B and C....................	$15,000.00	
To Notes payable.............		$10,000.00
Accounts payable..........		5,000.00
For the assumption of their liabilities by this company as part consideration of the purchase of their assets.		

The next step is to issue the stock to the firm, so the following entry is made in the journal:

A, B and C....................	$60,000.00	
To Subscription to preferred capital stock...............		$45,000.00
Subscription to common stock		15,000.00
For 450 shares of preferred stock and 150 shares of common stock, issued to them as per their subscription, for which they pay in property instead of cash.		

It will be noticed that the purchase of the assets has been recorded by merely debiting the account entitled "plant and sundry assets." This is the policy generally followed for the reason that the assets may be acquired at one value and placed on the books of the corporation at a different value. To close out

BALANCE SHEET OF THE A, B, C MANUFACTURING COMPANY, AS ON 192-

ASSETS:

Cash		$ 5,000.00	
Notes receivable	$3,000.00		
Accounts receivable ...	9,000.00	12,000.00	
Merchandise inventory .		15,000.00	
Materials and supplies.		8,000.00	$40,000.00
Real estate		25,000.00	
Machinery and tools...		10,000.00	35,000.00
			$75,000.00

LIABILITIES:

Notes payable		$10,000.00	
Accounts payable		5,000.00	$15,000.00

CAPITAL:

Capital Stock:			
Authorized:—			
Preferred	$50,000.00		
Less unsubscribed...	5,000.00	$45,000.00	
Authorized:—			
Common	50,000.00		
Less unsubscribed...	35,000.00	15,000.00	60,000.00
			$75,000.00

the account "plant and sundry assets," and to place the various assets on the books of the company are the next operations. These are accomplished by means of the following journal entry:

Real estate	$25,000.00	
Machinery and tools	10,000.00	
Merchandise inventory	15,000.00	
Materials and supplies	8,000.00	
Notes receivable	3,000.00	
Accounts receivable	9,000.00	
To plant and sundry assets		$70,000.00
For the purpose of placing the respective assets on the books of the company.		

It is advisable in all such cases to test the accuracy of the work accomplished and for this purpose a balance sheet should be prepared. It is preferable to prepare a balance sheet rather than a trial balance because there are no nominal accounts. The balance sheet would be as shown on the preceding page.

4. *Liquidation of a corporation.*—The important features of the liquidation of a partnership have already been considered and it has been pointed out that the creditors were paid off first, any losses being charged against the partners' capital accounts in the ratio in which they agreed to share profits or losses. The balance of the assets, if any, were paid out to the partners on the capital ratio. In the event of the liquidation of a corporation the same procedure is followed with reference to the payment of creditors. The profit-and-loss-sharing ratio and the capital ratio

in a corporation are always the same, because shareholders share profits or losses pro rata, according to the number of shares which they hold. Therefore, the liquidator is not under the necessity of watching the capital account in the case of a corporation, as he would be in a partnership where the profit-and-loss-sharing ratio was different from the capital ratio.

In winding up the affairs of a corporation, the capital stock account will be debited for the shares returned to the corporation by the stockholders, and surplus, or winding up account, will be credited; the surplus account, or the winding up account, will be debited with the payments which have been made by the liquidator to the stockholders for liquidation dividends. The surplus account, or winding up account, will also be debited with any losses sustained on realization, and likewise credited with any profits realized. The balance, if any, will then be distributed to stockholders in the proportion in which they held shares of stock.

5. *Reduction of capital stock resulting in the creation of a surplus.*—The laws of most states impose restrictions upon a reduction of the capital stock for the purpose of protecting creditors, the general tenor of the laws being that a corporation may not reduce the amount of its capital stock to an amount less than that of its liabilities. In some cases, a corporation may desire to wipe out a deficit by reducing the amount of its capital stock, and this practice is probably correct under the law, provided, that the capital

stock is not reduced to such an extent that the debts of the corporation exceed it in amount. To illustrate: If the assets of a corporation amount to $210,000, its debts to $100,000, and the capital stock outstanding to $175,000, there is evidently a deficit of $65,000.

It is probably legal for the corporation to reduce its capital stock to $100,000, crediting the amount of $75,000 to the deficit account, thereby converting it to a surplus account with a credit balance of $10,000. It would undoubtedly be improper to reduce the capital stock to an amount less than $100,000 for the reason that the outstanding liabilities of the company equal that amount.

6. *Surplus is available for distribution.*—There is no doubt but that the amount of $10,000, now standing at the credit of the surplus account, will be available for the distribution to stockholders as a dividend, altho it is not a dividend in the usual sense since it arises from the fund originally contributed for capital. In the case of the Continental Securities Company vs. Northern Securities Company (66 N. J. Equity 274) the court in passing upon a similar distribution said: "The proposed distribution is not a dividend in the sense intended by the statute, but a division of the surplus capital rendered useless for the purposes for which it was originally contributed to capital."

It also follows that the corporation would not be able to pay more than the amount standing at the

credit of surplus account, because such distribution would impair the remaining capital stock. The important point to be noted, therefore, is that a return of an original capital contribution is not a dividend [1] in the sense in which the latter term has been used, because it does not represent surplus profits arising from the business. Furthermore, it has been held that unpaid cumulative preferred stock dividends are not entitled to any portion of a surplus distribution of this kind, but that the amount must be distributed among the stockholders without preference.

REVIEW

What books of record would be found in a corporation in addition to those found in a partnership, and what is the purpose of each?

Under what different methods may corporate books be opened? What is the object of keeping an account with the subscribers to capital stock?

If you were called upon to close the books of a partnership the members of which had decided to organize in corporate form, what steps would you take to close the books of the old firm and open those of the new firm?

In the problem accompanying this chapter, what is the use and object of the plant and sundry assets account? What disposition is ultimately made of this account?

[1] See decision in the case of Roberts vs. Roberts-Wick Company, 184 N. Y. 257.

CHAPTER XIII

BRANCH ACCOUNTS

1. *Reasons for the establishment of branches.*—When a business undertaking begins to extend the field of its selling operations beyond its immediate vicinity, it may become advisable to establish branches or agencies. Branches must be distinguished from agencies, for the reason that the former are practically departments of the parent concern, and are more or less self-managing. The latter are not departments of the parent concern; the relation between the undertaking and the agent is governed by a special contract. The advantages to be gained from the establishment of branches may be summarized as follows:

(1) It is much easier to keep in close touch with the trade and the activities of competitors by having in the field an organization whose policies are under the control of the home office, and whose salesmen are directly interested in, and concerned solely with, the product of the concern.

(2) If a large stock is carried at the branch office, deliveries can be more quickly made, and adjustments with customers can be more satisfactorily settled.

(3) Delivery expenses are reduced, because shipments can be made to the branch offices in carload lots instead of paying less than carload rates for ship-

ments made directly from the home office to individual customers. The carload rate can be obtained on shipments from the main depot to the branch office, and if the shipper bears the delivery expense, the saving in freight alone will be considerable in the course of a year.

(4) There is nothing to prevent an agent or jobber from ceasing to handle the product of a business concern at the expiration of his contract. The product sold by an agent or jobber is of course sold to the individual customers of the agent, and the shipper does not have that intimate relation with his ultimate consumers that he has if the product is handled thru his own branches. Obviously, moreover, a change of agent or jobber may result in a large temporary loss, or even in some permanent loss.

2. *Types of branches.*—The methods to be employed in installing a system of accounts for branches will depend upon the degree of authority and control which is to be vested in the local management, upon the nature of the business, and upon whether the sales are to be made entirely for cash or for both cash and credit.

Many concerns do not wish the branch managers to know the amount of the profit that the branch makes; if this is an important consideration, the system of accounts must be devised accordingly. It is clear that if the sales of a branch are made for cash, an elaborate system of accounts at the branch office will not be necessary. But if, as frequently happens, the

branch makes purchases of merchandise on its own account, it will probably be desirable to allow the branch to keep its own accounts.

3. *Simple type; general characteristics.*—Some of the widely known chain store businesses furnish good illustrations of the simple type of branch. The branch receives all its merchandise from the main office. The important items of expense, such as rent, salaries and delivery charges, are paid by the home office. The branch makes its sales for cash only. Each branch is supplied with a small amount of petty cash with which to meet expenses not paid by the main office. In a branch of this type, a system of comprehensive daily or weekly reports to be filled out by the local manager and forwarded daily or weekly to the main office, is all that is necessary.

All the sales of the branch will be recorded on a cash register, and not infrequently a daily record of sales is sent to the main office. A separate bank account will be provided for each branch manager, in which he must deposit his daily receipts. The bank agrees to allow only the home office to check this account, and also to mail to the home office a signed duplicate of the daily deposit slip. It will also be understood that the bank shall wire the home office immediately if the local branch manager fails any time to make the daily deposit.

4. *Method of taking inventory.*—All merchandise sent to the branch will be billed at sales prices; the branch manager will not, therefore, be aware of the

cost price of the goods, and it follows that he cannot know the amount of the gross profit made by the branch. The inventory of the branch will be taken at irregular intervals by auditors from the home office, who will report to the home office the quantity and kind of merchandise on hand. The home office will then price and extend the inventory, usually on both the cost and the sales price basis.

When the home office carries records of the goods shipped to branches at sales prices, a verification of the inventory is an easy matter. For example, it is clear that if branch A had on hand at the last inventory a stock valued at \$1,000 (sales price basis), and has received from the main office (during the interim) deliveries amounting to \$10,000 (sales price basis), and has reported sales amounting to \$7,000, the present stock on hand at the branch, estimated at sales prices, should amount to \$4,000. If the actual physical inventory exceeds this amount, and no errors have been made, there must have been a gain in the inventory. This may be brought about in several ways—for example, in the cigar business, when cigars of a certain brand sell "three-for-a-quarter," and three individual cigars of this particular brand are sold for ten cents each.

In practice, this difficulty is frequently overcome by putting out a brand that is worth ten cents at retail to be sold to a customer who desires one cigar for ten cents. It may also happen that the inventory will reveal a loss—for example, (1) when sales are made

and not recorded; (2) where thefts have been committed, either by customers or by employes; (3) when breakage or shrinkage has occurred. Any unusual gain or loss in the inventory should be carefully investigated.

5. *Accounts kept by branch offices.*—Under this system each branch will have upon the home office books a merchandise account, an analytical expense account, and possibly a branch profit-and-loss account. The merchandise account will probably be specially devised to provide for the record of the inventory on hand at the beginning of the period, and for deliveries to the branch, upon both a cost and a sales price basis. Form A on page 213 shows how the gross profit on sales is determined when a method similar to that outlined above is employed. An analytical branch expense account, for expenses paid by the home office, as well as for expenses paid out of the petty cash fund of the branch, is shown in Form B. The branch profit-and-loss account illustrated in Form C shows how the net profit from the operation of the branch is ascertained by this method.

6. *Relation between the home office and the branch offices.*—The shipments to the branch are charged to the branch merchandise account at both the cost and the sales price, and are credited to the main office stock account, or purchase account, at cost price only. In the cash book of the main office a current analysis is kept of the cash receipts, by branches; or if it is not convenient to keep this detailed record in the general

BRANCH A—MERCHANDISE ACCOUNT

DATE	EXPLANATORY	FOLIO	DEBITS COST PRICE	DEBITS SALES PRICE	DATE	EXPLANATORY	FOLIO	CREDITS COST PRICE	CREDITS SALES PRICE
192–					192–				
Jan. 1	To Inventory		$2,000 —	$3,000 —	Jan. 8	By Sales for Week			$700 —
" 10	Shipments to branch		1,600 —	2,400 —	" 15	" " "			1,300 —
" 25	" " "		2,400 —	3,600 —	" 22	" " "			1,200 —
" 29	" " "		4,200 —	6,300 —	" 29	" " "			800 —
					" 31	" to date			350 —
					" 31	Returns goods not ordered		$300 —	450 —
					" 31	Inventory		7,000 —	10,500 —
						Branch A-P. & L. a/c		2,900 —	
			$10,200 —	$15,300 —				$10,200 —	$15,300 —

Form A

BRANCH A—EXPENSE ACCOUNT

DATE	EXPLANATORY	FOLIO	TOTAL DEBITS	RENT	SALARIES	HEAT & LIGHT	CLEANING	CREDITS
192–								
Jan. 1	Voucher #21		$700 —	$650 —	$50 —			
" 15	#28		59 —		50 —	$5 —	$4 —	
" 31	#32		57 —		50 —		7 —	
" 31	To P. & L. a/c							$816 —
			$816 —	$650 —	$150 —	$5 —	$11 —	$816 —

Form B

BRANCH A—PROFIT AND LOSS ACCOUNT

DATE	EXPLANATORY	FOLIO	AMOUNT	DATE	EXPLANATORY	FOLIO	AMOUNT
192–				192–			
Jan. 31	To Cost of sales as per merchandise account		$2,900 —	Jan. 31	By gross sales as per cash-book analysis		$4,350 —
	Net profit to Surplus		634 —				
	Expenses		816 —				
			$4,350 —				$4,350 —

Form C

cash book, a special summary record is provided, in which will be entered the daily or weekly receipts, by branches. Each remittance from a branch will be credited to the branch merchandise account as received, and the entry in the cash book will constitute the debit corresponding to this credit.

At the end of each fiscal period the total cash receipts from branch A, for example, as shown in the analysis of the cash book, will be posted to the credit cf branch A's profit-and-loss account. The balance of the cost-price columns in the merchandise account at this point, will represent the cost of the goods sold by the branch, and will be transferred by a journal entry. The branch A profit-and-loss account will be debited for the amount of the difference, and this same amount will be credited to the merchandise account of the particular branch in the cost-price column only. By this method it is possible to determine from inspection the total sales, to date, of each branch, either by referring to the branch merchandise account or to the cash book analysis. The total amount of the shipments to each branch may be readily determined from the branch merchandise account. In the case illustrated it has been assumed that all merchandise was billed to the branch at 50 per cent above cost price. But even if varying rates of profit on the shipments to the branch were used, no difficulty would be encountered in determining the cost of the goods sold by the branch during the period, because it necessarily follows that the difference between the debit and

credit columns of the cost-price columns in the merchandise account, after the inventories at the beginning and at the end of the period have been taken into consideration, must represent the cost of goods sold.

7. *Complex type—branches keeping their own financial records.*—When sales are made upon credit, the transactions are necessarily somewhat more involved. In some cases, branches may deal in merchandise other than the line handled by the concern, in which event the purchases will usually be made on credit. Two methods are commonly employed when this situation prevails. According to the first plan, the branch will keep its own financial records, making its own sales and passing on its own credits. The branch manager will usually be allowed considerable freedom in handling the affairs of the branch. According to the second method, a comprehensive system of daily reports for the use of the branch is installed. From the information thus supplied, a separate set of financial records for the branch will be constructed in the home office.

Whether the first or the second method is employed, a controlling account will be kept for each branch in the main office ledger. When the second method is adopted, copies of all the records of original entry are forwarded to the home office. The cash record, the purchase record and the sales record are kept in duplicate and the original record is forwarded to the home office as soon as each page is completed, and at the end of each month the last page is forwarded,

whether it has been entirely filled or not. The duplicate is retained at the branch, which keeps its own ledger. At the end of every month the branch will send to the home office a copy of the trial balance of each ledger.

8. *Duplicate records.*—The home office will reconstruct the ledger accounts from the original records received from the branch, and will check its trial balance against that forwarded by the branch. This plan involves duplication of work. It is not employed to any extent by American houses, but is used by many foreign houses that operate American branches. The advantage of keeping duplicate records at the home office consists principally in the fact that those records may be the means of saving many thousands of dollars if the branch records are destroyed by fire.

The following problem illustrates the method of handling branch accounts under the first general plan mentioned above.

The trial balance given below was taken from the general ledger of the Smith Wire Goods Company of New York on June 30, 192–:

	Dr.	*Cr.*
Land and buildings—New York......	$40,000	
Land and buildings—Chicago warehouse	10,000	
Plant and machinery—New York.....	10,000	
Inventory — January 1, 192– — New York office	20,000	
Inventory—January 1, 192– —Chicago branch	4,000	

	Dr.	Cr.
Purchases	$80,000	
Shipments to Chicago branch		$15,000
Accounts receivable	10,000	
Cash	8,000	
Chicago branch account		7,000
Expenses	7,000	
Sales		70,000
Capital stock		80,000
Accounts payable		9,000
Reserve for depreciation		8,000
	$189,000	$189,000

The trial balance of the Chicago branch office at the same date disclosed the following:

	Dr.	Cr.
Cash	$4,000	
Accounts receivable	5,000	
Purchases	7,000	
Goods received from New York office	15,000	
Expenses	6,000	
Sales		$40,000
New York office account	7,000	
Accounts payable		4,000
	$44,000	$44,000

The inventory on hand on June 30, 192–, was as follows: New York, $18,000; Chicago, $3,000. Provide for depreciation: on New York realty $5,000; Chicago realty $500; plant and machinery $1,000.

Prepare a consolidated balance sheet and profit-and-loss statement; furnish journal entries to close both ledgers.

Chicago Books

Sales	$40,000	
To purchases		$ 7,000
Goods received from New York office		15,000
Expenses		6,000
New York office account		12,000
to transfer		

New York Books

Inventory—New York office—new account	18,000	
Inventory—Chicago branch—new account	3,000	
To Inventory—New York office—old account		18,000
Inventory—Chicago branch—old account		3,000

New York branch profit-and-loss account	2,000	
Chicago branch profit-and-loss account	1,000	
To Inventory—New York office—old account		2,000
Inventory—Chicago branch—old account		1,000
To transfer the difference in inventories to the former accounts.		

New York branch profit-and-loss account	6,000	
for depreciation on realty $5,000 and depreciation on plant and machinery $1,000		
Chicago branch profit-and-loss account	500	
for depreciation on Chicago realty		
To Reserve for depreciation		6,500

Chicago branch profit-and-loss account		$28,000	
Goods received from New York office	$15,000		
Purchases	7,000		
Expenses	6,000		
To Chicago branch account			$28,000
Chicago branch account		40,000	
To Chicago branch—profit-and-loss account—Sales $40,000			40,000
to give expression to the closing entries of Chicago books.			
New York profit-and-loss account		87,000	
To Purchases			80,000
Expenses			7,000
to transfer			
Sales		70,000	
Shipments to Chicago branch		15,000	
To New York profit-and-loss account			85,000
to transfer			
Chicago profit-and-loss account		10,500	
Profit for period			
To New York profit-and-loss account.			10,000
Loss for period			
Surplus			500
Net profit on operations			

SMITH WIRE GOODS COMPANY.
Consolidated Trial Balance June 30, 192–

ACCOUNTS	NEW YORK		CHICAGO		TOTAL	
	DR.	CR.	DR.	CR.	DR.	CR.
Land and buildings–New York	$40,000				40,000	
Land and buildings-Chicago Warehouse	10,000				10,000	
Plant and machinery–New York	10,000				10,000	
Inventory–January 1, 192–New York	20,000				20,000	
Inventory–January 1, 192–Chicago	4,000				4,000	
Purchases	80,000		$7,000		87,000	
Shipments to Chicago Branch		$15,000				
Goods received from New York Office			15,000			
Accounts receivable	10,000		5,000		15,000	
Cash	8,000		4,000		12,000	
Expenses	7,000		6,000		13,000	
Sales		70,000		$40,000		$110,000
Capital Stock		80,000				80,000
Accounts payable		9,000		4,000		13,000
Reserve for depreciation		8,000				8,000
Chicago Branch Account		7,000				
New York Office Account			7,000			
	$189,000	$189,000	$44,000	$44,000	$211,000	$211,000

SMITH WIRE GOODS COMPANY.

Working Sheet for Consolidated Statement June 30, 192–

ACCOUNTS	TRIAL BALANCE		ADJUSTMENTS		PROFIT AND LOSS		BALANCE SHEET	
	DR.	CR.	DR.	CR.	DR.	CR.	DR.	CR.
Land and buildings–New York	$40,000						$40,000	
Land and buildings–Chicago	10,000						10,000	
Plant and machinery–New York	10,000						10,000	
Inventory–1/1/192– New York	20,000			$18,000	$2,000			
Inventory–1/1/192– Chicago	4,000			3,000	1,000			
Purchases	87,000				87,000			
Accounts receivable	15,000						15,000	
Cash	12,000						12,000	
Expenses	13,000				13,000			
Inventory–6/30/192– New York			$18,000				18,000	
Inventory–6/30/192– Chicago			3,000				3,000	
Depreciation–New York realty			5,000		5,000			
" –Chicago "			500		500			
" –Plant and machinery			1,000		1,000			
Profit and loss			500		500			
Sales		$110,000				$110,000		
Capital Stock		80,000						$80,000
Accounts payable		13,000						13,000
Reserve for depreciation		8,000		5,000				14,500
				500				
				1,000				
Surplus				500				500
	$211,000	$211,000	$28,000	$28,000	$110,000	$110,000	$108,000	$108,000

SMITH WIRE GOODS COMPANY

Balance Sheet—June 30, 192–

Assets			*Liabilities and Capital*	
Current assets:			Accounts payable	$ 13,000
Cash	$12,000		Reserve for depreciation	14,500
Accounts receivable	15,000		Capital stock	80,000
Inventories	21,000		Surplus	500
Total current assets		$ 48,000		
Land and buildings		50,000		
Plant and machinery		10,000		
Total assets		$108,000	Total liabilities and capital	$108,000

SMITH WIRE GOODS COMPANY

Profit-and-loss statement for six months ended June 30, 192–.

Sales		$110,000
Cost of sales:		
Inventory January 1, 192–	$ 24,000	
Purchases	87,000	
	$111,000	
Less inventory June 30, 192–	21,000	
Cost of sales		90,000
Gross profit on sales		$20,000
Expenses		13,000
Net profit on sales		$ 7,000
Profit-and-loss charges:		
Provision for depreciation		6,500
Surplus for current period as per balance sheet		$500

9. *Solution of the problem—general comments.*—An examination of the trial balance at the home office discloses the fact that the real property of the branch is carried on the home office ledger instead of on the branch ledger; this is not an uncommon practice. It will also be seen that the inventory at the beginning of the period, at the branch, is carried on the home office books. It is evidently the intention not to inform the branch manager as to the profits of the branch. Obviously, if he is not informed as to the inventory, it will not be possible for him to determine accurately the profit on trading. Altho he will of course know what the home office is charging him for the merchandise, he will not know what the goods cost the home office.

The next account to consider is the account, "Shipments to Chicago Branch, $15,000." There is a corresponding account found in the trial balance of the branch, entitled "Goods Received from New York Office, $15,000." When the home office shipped goods to the branch, the amount of the bill was charged to the branch account on the home office books, and credited to the account, "Shipments to Chicago Branch."

10. *Relations with branches in consolidated balance sheet.*—Both of these accounts have been eliminated from the consolidated trial balance. Since transfers of merchandise from the home office to the branch are not to be considered as sales by the former, or as purchases by the latter, the transaction constitutes merely

a shifting of the inventory. Tho it may be the custom of the home office to bill the goods to the branch at an arbitrary price, or at a price above cost, no actual profit is realized until the branch has sold the merchandise to its customers. Therefore, when a consolidated profit-and-loss account is prepared, showing the operations of both the home office and the branch, both of these accounts should be eliminated.

11. *How the home office treats shipments to branches.*—But it should be carefully noted that, on the other hand, when the home office is considered as a separate unit for the purpose of determining its profit, as separate and distinct from the branch profit, it will be necessary to treat as sales the shipments to the branch. Also, when the branch records are analyzed for the purpose of arriving at the profit of the branch, it will be necessary to consider deliveries from the home office as purchases. The important point is, that when a consolidated statement is prepared, inter-branch transactions must be eliminated, while if the individual-income accounts are treated, inter-branch transactions should be included.

12. *How branch accounts handle goods from home office.*—Sometimes the practice is to treat the branch as a customer; the amount due from the branch will then be taken up in the balance sheet of the undertaking as an account receivable. This method is decidedly incorrect and should never be adopted.

The net amount due to the branch, or from the branch, must be stated under a caption clearly ear-

marked so as to indicate its true character. A better method would be to consolidate the individual assets and liabilities of the branch with the individual assets and liabilities of the home office, in preparing a balance sheet of the business as a whole. This is the method which has been employed in the solution of this problem.

13. *Closing the branch books.*—An examination of the trial balance of the branch shows that this branch makes purchases of merchandise on its own account, in addition to receiving goods from the home office. When the inventory of merchandise is not carried upon the branch books, there is no object in opening a profit-and-loss account upon the branch books because a profit-and-loss account cannot be properly prepared by it from the information in its possession.

It is therefore customary to close the branch books thru the home office account, debiting the home office account with nominal accounts showing debit balances, and crediting the home office account with nominal accounts having credit balances. At the end of the fiscal period the branch will send a copy of its final trial balance, before and after closing, to the main office, as well as its closing journal entry. This entry will be taken up on the home office books in the manner indicated in the solution.

When the books at the home office are closed, the depreciation upon the real property of the branch will be charged to the branch profit-and-loss account, in

order that the net profit from the operation of the branch may be shown in that account.

14. *Profit-and-loss account; the branch office.*—The following problem and solution illustrate the method employed in determining profit-and-loss of the branch when it is customary to charge the branch a price greater than the cost of the merchandise to the home office. The principal point to be noted in this solution is, that in the preparation of the final accounts, a reserve must be set up on the home office books to take care of the profit appropriated by the home office in the original charge of the goods to the branch, as regards those goods which have not yet been sold by the branch.

PROBLEM

A company has several branches which are supplied from the home office. Each branch has its own sales ledger, and hands over to the main office each day the total amount of cash received. All goods shipped from the main office to the branch are invoiced at 20 per cent above cost. All expenses are paid from the main office. From the following particulars of the transactions at the branches, raise the ledger accounts in the main office books, and prepare an account that will show the gross profit.

	Chicago	*New York*	*Boston*
Goods received from main office..	$5,500	$4,500	$3,500
Total sales	5,200	4,300	3,100
Cash sales	2,750	2,250	1,650

	Chicago	*New York*	*Boston*
Cash received on ledger accounts..	$2,250	$1,850	$1,250
Debtors at beginning	1,555	1,665	1,350
Debtors at close	1,755	1,865	1,550
Stock of goods at beginning	750	650	450
Stock of goods at close	1,060	960	760

SOLUTION

CHICAGO BRANCH ACCOUNT

To Balance	$2,305	—		By Cash	$5,000	—
Merchandise	5,500	—		Balance	2,815	—
Home office – profit	10	—				
	$7,815	—			$7,815	—
To Balance	$2,815	—				

NEW YORK BRANCH ACCOUNT

To Balance	$2,315	—		By Cash	$4,100	—
Merchandise	4,500	—		Balance	2,825	—
Home office – profit	110	—				
	$6,925	—			$6,925	—
To Balance	$2,825	—				

BOSTON BRANCH ACCOUNT

To Balance	$1,800	—		By Cash	$2,900	—
Merchandise	3,500	—		Home office – loss	90	—
				Balance	2,310	—
	$5,300	—			$5,300	—
To Balance	$2,310	—				

PROFIT-AND-LOSS ACCOUNT

To Loss – Boston branch	$90	—		By profit – Chicago Branch	$10	—
Reserve for profit on branch inventory (20% of $2,780)	556	—		profit – New York "	110	—
				Reserve for profit on branch inventory (20% of $1,850)	370	—
				Balance loss for period	156	—
	$646	—			$646	—

RESERVE FOR PROFIT ON BRANCH INVENTORIES

To Profit and Loss – transfer of reserve	$370	—		By profit on branch inventories (20% of $1,850).	$370	—
				By profit on branch inventories (20% of $2,780).	$556	—

15. *Solution of the problem; comments.*—The initial balances in each branch account consist of the amount of the debtors' accounts and the stock of goods at the beginning of the period. Each branch is credited with the amount of cash that it remits to the home office; and at the end of the period the amount of the debtors' accounts at the close of the period, and the stock of goods on hand at that time, are included in the account. The balance of the account represents net profit or loss, and is transferred to the home office profit-and-loss account.

It will be noted that the profit or loss shown is the profit or loss after credit has been allowed at the home office for a profit of 20 per cent on all goods sold. Inasmuch as the merchandise is charged to the branch at an advance of 20 per cent, it will be necessary to provide in the home office accounts for a reserve to take care of the overvaluation of the branch inventory. It would be incorrect to take credit for this profit, since the goods are still on hand at the branch. Therefore a reserve equivalent to 20 per cent of the amount of the inventory that appears on the branch books is charged to profit-and-loss, and is credited to the reserve for profit on the branch inventory.

The reserve at the beginning of the period amounted to $370. Now that the goods have been sold, the reserve has served its purpose, and the profit of 20 per cent on the inventory at the beginning of the period has been realized. The amount of this reserve is

therefore credited to the profit-and-loss account, and a new reserve is created at the end of the fiscal period equivalent to 20 per cent of the amount of the inventory on hand at the branches at the close of the period.

16. *Valuation of branch inventories.*—Another problem that arises is the valuation of branch inventories. A paper-manufacturing company has a main office in New York and mills located elsewhere; the mills invoice paper to the New York office at cost, plus 25 per cent. The expense of bringing the paper to New York is approximately 5 per cent of the invoice price paid by the New York office. The question is how to value the paper stock in New York at the close of the fiscal period. For the purpose of illustration, let it be assumed that an invoice of paper which costs $80 to manufacture, is charged to the New York office at an advance of 25 per cent, or $100; the cost of delivery to New York is an additional $5. When the freight was paid by the New York office it would no doubt be charged to an inward-freight account on the New York books, and when the books at New York were closed the inventory would probably be taken by the New York office at invoice prices.

17. *Stock-taking; the inventory.*—To arrive at a proper basis for stock-taking, it will be necessary to reduce the inventory value by 20 per cent of the invoice prices. Is it proper, however, to include as a part of the inventory cost, the expense of the freight paid in getting the goods to New York? If the mer-

chandise can be sold only in New York, the freight paid by the New York office will be properly considered as a part of the incidental expenses necessary to get the goods to market.

Therefore, the inventory taken at cost prices will be loaded with one-sixteenth, or 6¼ per cent, and a corresponding amount will be credited to the inward-freight account. This will reduce the charge made against the income account during the period, by the estimated freight charges on that portion of the paper as yet unsold by the New York office.

REVIEW

Prepare a brief outline for a system of accounts for a concern with branch stores which make sales for cash only, and which receive their stock from the main office.

What system—complex type—should be employed in keeping the accounts of branches?

What plan would you suggest for taking care of the inter-branch transactions so as to treat them as separate from purchases and sales?

How should the amount due from a branch at the end of a fiscal period be treated in the balance sheet of the organization?

PART II

AUDITING

CHAPTER I

THE AUDITOR AND HIS WORK

1. *Introductory.*—Altho accountancy, as a profession, has been legally recognized in the United States since 1896, there are many business men who are unfamiliar with the work of the auditor. Either they regard him simply as one to call upon when the unfortunate necessity arises of straightening out a tangled set of accounts, or they employ him only when the cashier has absconded, for the purpose of finding out how much the undertaking should charge as a loss to "running expenses."

It is not the intention in these pages to speak of the auditor and his work from the standpoint of the student of auditing, altho many facts and principles that would be of interest to anyone preparing for the profession will be brought out. The intention is to treat of the subject from the point of view of the business man and his relation to his confidential adviser. The reader will find what advantages result from the employment of a competent reviewer of accounts. The nature of the work of the auditor will be considered, in order that the business man may better cooperate with him in it and judge intelligently the value of the work which the auditor does for him. The business executive should know, also, the standard

practices of the profession so that he will be enabled to differentiate between the different classes of engagements.

2. *Definition of auditing.*—The general purpose of auditing has been described in the Text on "Accounting Principles." There is considerable difference of opinion as to whether the functions of the auditor should be circumscribed within the narrow limits which the derivation of the word would suggest. Mr. Robert H. Montgomery, C. P. A., holds to the view that the auditor is more than an analyst because the "logical development of the profession, and the increasing appreciation of the value of his work, have added to his former duties certain constructive functions which must be fulfilled in connection with a large proportion of his engagements." Others compare the auditor to the engineer who looks for faulty and weak or insufficient construction, while still others assert that the auditor's function should not be that of trying to find things that are incorrect, but rather that of trying to prove that the work which has been done has been accurately performed. There is considerable difference in the point of view, and the effectiveness of the audit will depend somewhat upon the attitude with which the auditor approaches his work. Under the old English Company Act, the auditor was supposed to be responsible for the management of the office. He was expected to establish the system, or to approve or disapprove of the system in force. The majority of auditors in America seem to have a wider

conception of the duties of the auditor than is generally held by their confrères in Great Britain.

3. *What auditing embraces.*—Everyone will probably agree with the definition of auditing that makes it cover a systematic inspection of all books of account and subsidiary records, in order to prove the accuracy of all transactions recorded; and to trace fraudulent entries, technical errors and errors of principle. This definition also involves the criticism of inaccurate or faulty methods of account keeping, and includes the suggestion of better and more improved methods. It also embraces the interpretation of the results of the records examined, because the auditor must either state the results correctly himself or certify to or alter an interpretation of facts prepared by another.

4. *The economic function of the professional auditor.*—It will probably be accepted that the auditor has a definite, economic function. When it is realized that those who are charged with keeping financial records frequently make errors, either by design, ignorance or carelessness, the necessity of an independent review of accounts becomes self-evident. It will also frequently happen that those who are capable of recording financial facts accurately and truthfully, are not able to compile them properly, or to present them in such a manner as will admit of intelligent comparison. The permanent employment of one qualified to perform these functions would, in the case of many businesses, be an unjustified expense. Hence, the need and demand for an impartial review of finan-

cial accounts, for one purpose or another, has given rise to a class of professional men qualified to do the work. The laborer in the shop requires a foreman to oversee his work and to direct his energies. In a similar manner, those whose work deals with the labor of keeping accounts require not only intelligent direction, but also aid and assistance in a comprehensive interpretation of the net results and effects of the transactions of a business organization. If the laborer would not waste time or material or misdirect his energy, there would be no need of a superintendent. Likewise, if bookkeepers could always be relied upon to do their work correctly, and if business men and proprietors could always be depended upon to present honest statements of business conditions, the services of the professional auditor would be unnecessary.

5. *Auditors classified.*—In view of the importance of the work which the auditor is called upon to perform, legislators have seen the wisdom of protecting the public, as far as the law can do so, against the entrance of incompetent persons in this special field. In England, Scotland, Canada, and in the greater portion of the United States, the law now regulates the practice of public accountancy by compelling those who are about to enter it to have certain educational and professional qualifications. The law stipulates that upon those who qualify upon examination, a specific title shall be conferred. In the United States, one admitted to practise publicly is known as a Certi-

fied Public Accountant. One who is qualified to practise in England, Scotland or Canada is known as a Chartered Accountant.

6. *Laws regulating the profession are not uniform.* —Unfortunately, however, the laws in the various states show a marked difference in the qualifications demanded for accountants. In an instance in which a certain state passed a C. P. A. law the legislature subsequently granted an exemption to individuals to qualify as certified public accountants without examination. In other states, the educational requirements are not insisted upon, so that the title of Certified Public Accountant has less significance than if all the states had uniform laws and practices on this subject.

7. *Qualifications of an auditor.*—Not everyone is qualified, either by nature or by training, to practise the art of auditing, and as there are many unqualified men in the field, it is the more desirable that the business man should know something of the proper qualifications of those who practise accounting publicly. The qualifications may be divided into three classes: natural qualifications, general training and education, and professional training and education.

8. *Natural qualifications.*—Nature has endowed certain individuals more than others with the analytical and interpretive faculty. Those who are possessed of these faculties have the power to weigh and coordinate facts, to think clearly without prejudice and to arrive at their results by what almost seems to be

intuition. Furthermore, they are enabled to accomplish these results quickly and correctly. It is self-evident, therefore, that those who do not possess such natural qualifications will not make good auditors.

9. *General training and education required.*—Natural abilities should be reenforced by an excellent general training and education. The laws of most states which regulate the practice of public accountancy generally require that those who hold the state degree shall have at least a high school education. The advantage of this requirement has been questioned by some, because there are many excellent auditors in actual practice who have not had the complete education offered by the secondary school. The excellent work of these men is used as an argument against what is called the narrowing and restrictive policy requiring a certain amount of elementary school education for those who are to practise publicly under the approval of the state authorities.

If the view is held, however, that the auditor is more than a mere bookkeeper, not content with checking the accuracy of the accounts; or if it is believed that his functions are constructive and often creative, it would seem that the general training and education required for an auditor should include at least a high school education. In fact, it should embrace a knowledge of the science of economics, finance and the entire field of business—in brief, the knowledge which a man derives from pursuing a course of study such as is offered in the Modern Business

Course and Service. If the auditor does not bring to his work the benefit of this broad, general training he will probably fail in his mission, and his clients will not receive the benefits from his services that they are justified in expecting.

10. *Professional training and education.*—Before one can practise auditing publicly, in Great Britain, it is necessary to have served an apprenticeship in the office of a practicing public accountant. In the United States the laws of some of the states provide that those who pass the written examination for accountants, before they receive the degree of certified public accountant, shall have had a certain number of years of training in the office of an accountant, and shall have studied a certain number of years in a recognized school of accountancy. Too much stress cannot be laid upon the necessity of the requirement for broad professional training and education. The time required by the majority of states for the training of accountants, under their present laws, appears to be altogether too short.

Many men have passed the written examinations for the degree of certified public accountant who have never seen a single day's experience in the office of a practicing public accountant. Most of the examinations are of such a character that they can be passed by anyone who has "crammed" intelligently for the purpose. So that, while a person employing a certified public accountant receives practically an assurance from the state that the individual is qualified

to practise, it is unfortunately true that this assurance cannot always be relied upon. Therefore, the business man should examine carefully into the qualifications of the professional auditor before employing him.

11. *Danger in employing unlicensed auditors.*—The business man should beware especially of employing those who are not licensed to practise; that is, men who do not hold the title of C. P. A., or the title of C. A., unless he has evidence that they possess the required professional ability. The presumption is against them. Men without the accountant's degree often argue that the examiners and state boards of public accountancy are not fair, that they set unfair examinations and that the examinations are not practical in character. As a general rule, the facts are otherwise; examiners as a class are conscientious, and they attempt to do justice to their office by setting not only proper examinations, broad in character, but also attempt to advance the profession by granting certificates to all whom they consider worthy. On the other hand, the examiners have a duty to perform to the community and should refuse to grant certificates to those who, by examination or experience, show themselves to be improperly qualified.

12. *Whom not to employ.*—For a professional acacountant to advertise or to solicit business, is looked upon as violating the ethics of the profession, altho there is a difference of opinion on this question among the leaders. There is also some prejudice against

auditing companies on the ground that the element of personal responsibility is absent, inasmuch as the principals or individuals shield themselves behind the corporate body. Nevertheless, it must be admitted that many companies engaged in practice are not only thoroly responsible but also do auditing work of the highest character. These matters are the subject of considerable discussion in the profession and, with the progress of time, a definite and well-defined code of ethics regulating both advertising and organization under corporate form will doubtless be established. At present, however, the fact that a professional auditor advertises to a certain extent, or engages in business under corporate form, is not necessarily an indication that he should not be employed. It must be remembered that the profession is comparatively young in this country, and it will doubtless take some time to establish uniform practice in these respects.

When one considers the thoro training and the years of preparation that are required to enable one to properly practise accounting, it will be evident that the services of an auditor of the proper type are just as valuable to the business man as those of a good lawyer. In an important legal matter, the business man would not think of engaging a charlatan, or a man who offered to do the impossible, or who offered to do the work for a fee much less than that which would be charged by any reputable practitioner. And yet the same individual will frequently employ men as auditors who are not properly qualified to do the

work, or who will compete for it at a price far below that justified by its character. A man in any profession who indulges in cut-throat competition or in lurid advertising, stamps himself as one without enough work to keep him properly employed. For this reason alone, the business man should decline to employ his services. The business executive should not expect a reputable professional accountant to enter into competition, bidding as building contractors would do, nor to undertake work which cannot be honestly and properly done at the price agreed upon.

13. *Some of the difficulties experienced in estimating fees.*—On the other hand, the business man should not go blindly in the matter of securing an accountant and allow himself to pay an excessive price for the service. He will find that a reliable firm of accountants will spend considerable time and expense in making a preliminary survey of the work to be done in order to tell him about the length of time that the work will require, and the probable amount of the expense that will be entailed. In doing this, the auditor must also provide for a margin of safety. Experience has demonstrated that in many cases a set of accounts, apparently properly and accurately kept, contain a number of errors of principle and, in some cases, entries of a fraudulent character which delay the work, or which require in the correction of it a greater amount of time than was anticipated.

Therefore, the suggestion which the author makes to the business man who is about to employ an auditor,

is this: if he, himself, knows of no one who is competent to undertake the work, he will undoubtedly find that his bankers or business acquaintances will be glad to suggest the names of one or more reliable practitioners. He may employ these men on a per diem basis, trusting to their professional honor to accomplish the work as speedily as may be consistent with thoroness and safety. Or, he may invite them to his place of business to examine the work to be accomplished, and to make recommendations as to the exact work which should be performed. After such examination and survey, the auditor will be in a position to estimate approximately the time it will take to examine the accounts. Based upon the estimate thus obtained from several careful practitioners, the business man may award the engagement to the one making the lowest and most reasonable estimate. But the mere fact that the price quoted by one is considerably lower than that of others should warn the business man of the possibility that the low bidder may not complete all the work which he agrees to do, or he may not do it as thoroly as those submitting the higher estimates.

14. *Incompetents are gradually being eliminated.*—Fortunately the business man is becoming more discriminating in his employment of auditors. The time will soon arrive when the incompetent will be automatically eliminated from the field and the properly qualified practitioner alone employed. The experience which was related by Mr. Frank W. Main, C. P.

A., in the *Saturday Evening Post* indicates very clearly the situation which has existed. Mr. Main says:

That there is much confusion in the popular mind as to the real work of the accountant and as to the very important service which he is rendering in the business world is not at all surprising.

Jobless bookkeepers without number, auditors of individual companies—seeing other fields of advancement closed,—and cost clerks, certain that their grasp of the one particular business with which they are familiar has given them a grasp of all businesses and a knowledge of all manufacturing problems, have started out in the professional field as full-fledged auditors, accountants, systematizers, and business experts, when, if experienced at all, their experience is confined to but one limited business. In some cases, at least, these auditors have about the same right to be known as professional accountants as a hospital orderly would have to palm himself off as a skilled physician.

The initial work which usually falls to the lot of the self-styled accountant on his first incursion into the professional field is usually in a line of business somewhat of the same nature as the one he has recently left. With the nerve which was necessary to start out for himself, and with his practical experience in that particular line, he is often able to render valuable service to his client. As time goes on, however, and as his business is extended into other lines, his difficulties increase; for unconsciously the effort is made to conform all business to the methods and the systems of the one concern with which he is most familiar. As a result, ludicrous situations usually arise and the usual experience is that after heroic efforts of a few years he is glad to accept some permanent position at an assured salary with an established concern.

In his trail, however, are usually left scores of business men with the well-grounded belief that their own bookkeepers

know all that any professional accountant does, and with the conviction that the paying to the accountant of the fees which he demands is only foolishness, as they are certain that the same services can be as well rendered by their own employes.

If the business man would realize the fact that the qualifications of the professional auditor of the right type are something worth paying for, he will more wisely expend his money. Perhaps the following quotation from Mr. A. Lowes Dickinson, a well-known leader in the accounting profession in this country, will express the attitude of the truly professional man:

The moral qualities called for are so high that it should place the profession at the head of all which come into contact with business affairs. The lawyer's duty is first of all to his client, and that duty frequently compels him to avail himself of technicalities, and other means of enabling that client to evade the law and its penalties; but the public accountant has only one duty to his client and to the public, and that is to disclose to him or for him, the truth, the whole truth, and nothing but the truth, so far as his abilities and special training to that end enable him to ascertain it. No legal quibble will save him from moral condemnation if he fails in this duty; no juggling with words and phrases will absolve him from responsibility, moral and often legal, for results which he has reason to know are not what they seem to be, or which, having regard to his special training in business affairs and accounts relating thereto, he ought to have known did not represent the facts. Whereas there may be and must be errors, and for errors made after full and proper precaution taken and due care exercised, no responsibility will lie, yet there is no profession in which the results of careless errors or misstatements will more certainly bring retribution.

REVIEW

What, in your opinion, does auditing embrace?

What consideration would guide you in the selection of an auditor for your individual business? Do you consider that you could advantageously employ the services of an auditor?

CHAPTER II

SCOPE OF AUDITOR'S ACTIVITY

1. *Widening the scope of the auditor's activity.*— Originally, as we have seen, the auditor's activity was confined to verifying the accuracy of certain accounts presented to him. While this is still one of his important duties, business men are learning to depend more and more upon the experience of the properly trained professional auditor for advice on other business problems. The scope of the auditor's activity includes the following:

(1) The audit, examination or certification of annual statements of accounts.

(2) The preparation and certification of statements of past results, as a preliminary either to the issue of new capital stock and debt or to the sale of the business. In the latter case the auditor's certification will probably form an important part of the prospectus issued by the underwriters of the securities.

(3) The preparation of statements of affairs and realization and liquidation accounts of organizations involved in financial difficulties. This phase of activity includes the preparation of reports to the government, as for example, income tax reports. It embraces further the preparation of required accountings

by the courts of those acting in a fiduciary capacity.

(4) General advice. The auditor is frequently called upon to act as arbitrator in disputes between partners or between members of a corporation. Not infrequently the advice of the auditor is sought regarding policies of internal organization and business expansion. The duties thus devolving upon practising public accountants are by no means light, and call for the exercise of the highest mental attainments.

2. *Audits and examinations.*—In this country the practising public accountant who acts as auditor for the corporation is usually appointed by the board of directors; he is therefore accountable to it and makes his report direct to the board. In England, the company auditor has always been appointed by the stockholders, and the present statute in Canada provides for the compulsory audit of the accounts of all Canadian banks by auditors selected by the stockholders who select one individual or firm to make the audit from a list of not less than forty qualified to do the work.

There is no doubt that many of the dishonest practices which have marked the past history of corporations in this country, would have been effectually prevented had the auditor been selected by the stockholders of the corporation. It is evident that where an auditor has been appointed by the board of directors, the board is at liberty to suppress his report if it is unfavorable, and cases are not unknown where favorable portions of an auditor's report have been

published and vital adverse criticisms made by him were suppressed. In other cases, excerpts from the auditor's report have been published which apart from the context were misleading.

3. *Corporate auditors should be elected by stockholders.*—The honest corporation manager has nothing to fear and, in fact, welcomes a thoro examination into his stewardship. The stockholders who have invested their money and who are, in the last analysis, the real owners of the corporation are gradually coming to assert their rights. It would seem desirable that state laws or by-laws of corporations to be organized in the future, should contain a provision for an independent report on the affairs of the company by an auditor appointed by the stockholders. The auditor should have access at all times to the books, accounts and vouchers of the company, and should be privileged to call upon any officer or employe for any information or explanation that he deems necessary. It should also be provided that the auditor's report be read as a part of the proceedings of the annual meeting, and that any stockholder may receive a copy.

An auditor's position should be safeguarded by a provision that he should not be removed without cause, and only upon vote at a stockholders' meeting in the notice of which the intention to displace the present auditor should be given due prominence. The auditor selected should be one licensed to practise because, in the event of his failure to discharge the duties of his position, there will be an opportunity to punish him

for wilful neglect by depriving him of his right to certify.

4. *Auditors of partnerships should be named in the articles.*—In the case of copartnerships, disputes over the interpretation of some of the articles of copartnership frequently arise and the firm may be dissolved at considerable loss. The services of a professional auditor are, in such cases, well nigh indispensable. As an outsider he may be depended upon to follow strictly the articles of copartnership and the intention of the members as expressed therein, and to see that the proper status of the individual members in respect to salaries, drawings and division of the profits is fairly stated. In the case of a limited partnership, where the law provides that the special partner has no right to interfere in the active management of the business, an audit would seem absolutely necessary in order that the limited partner may be sure of having his property rights safeguarded.

5. *Advantage of certified statements in securing bank loans.*—The great majority of business firms find it necessary from time to time to seek accommodations from bankers. The fact that the applicant for a bank loan has been accustomed to have his accounts audited by a reliable accountant, and the fact that he is able to present a properly certified balance sheet and statement of income, is an indication to the banker that the applicant is a careful business man. In the first place, the presentation of such a certificate removes the necessity of the banker's asking for one.

In the second place, the banker will have a better basis for judgment as to the ability of the borrower to pay the loan when it becomes due.

6. *Certified statements aid in the sale of a business or in the raising of new capital.*—When a business is about to be sold the purchaser not only desires to know the value of the assets and the amount of the outstanding obligations, but also the profitableness of the enterprise during a series of years and the probability of the continued enjoyment of profits.

The purchaser would be unwise to rely absolutely upon the statements of the vendor. An independent examination of the assets to determine whether or not they are truly stated, and whether or not the proper provisions for depreciation have been made, as well as to obtain a knowledge of the outstanding obligations and commitments is absolutely necessary. Furthermore, the vendor may be convinced that the profits are not likely to be continued, and may endeavor to sell the business on the basis of past results.

While it is generally true that when a man has parted with value on the basis of untrue statements recovery may be had, yet on the other hand, the intention of the vendor to deceive may be difficult to prove. Therefore, the wisdom of selecting a reliable auditor for this purpose is apparent, for he will not only see that unusual profits are not included in the income account but will also give due prominence to any unusual loss sustained. He will examine into the fluctuations in profits, especially with a view to their

continuance. He will see that all the proper expenses of management have been charged; that extraordinary economy in expenditure for repairs and renewals has not resulted in increased profits during the past period at the expense of the future. He will see that proper provision for depreciation of fixed assets, as well as circulating assets, has been made and whether items which should have been charged to revenue have been charged to capital to pad the capital accounts.

The audit will disclose whether or not the inventory has been properly valued, and whether the basis selected for valuation is correct. It is evident that the inventory forms an important part of the income account, and that an incorrect method of treating the inventory will not only affect the profits shown, but also the purchase price of the good-will of the business.

7. *Auditor's duty in the matter of estimating anticipated economies.*—While it is hard to lay down a general rule that will apply invariably in practice, it is doubtful if any attention should be paid to estimates made by an auditor regarding profits which are anticipated as a result of future economies. It often happens that the anticipated economies are not realized. In view of the fact that the auditor has no control over the situation, his estimate cannot be reliable, except in cases in which the management has definitely pledged itself to adopt certain reforms which will inevitably result in savings. Even where the vendors have retained a substantial interest in the

business, they are seldom sufficiently concerned to insure the promised economies. While it may be conceded that the accountant is probably in a better position than any other individual to forecast the future in this regard, and altho the management may pledge itself to adopt radical changes in policy and may work honestly and laboriously for the future good of the new consolidation, there are so many unforeseen contingencies that may arise that a careful and prudent auditor will not venture too far into the field of prophecy.

8. *Value of auditor's services to promoters.*—Again, the auditor can be of service to the promoter in gathering facts which the latter may submit in his prospectus and which shall not be made a part of the auditor's report. The investor himself will thus be left to determine whether or not the anticipated results are likely to be achieved. Take, for example, the case of a factory that has not been able to operate at full capacity owing to a lack of working capital. It may be true that with additional working capital the output can be greatly increased, and if the additional products manufactured can be sold as profitably as the output in the past, the return will undoubtedly justify the investment of additional funds. But it may also happen that the additional cost of marketing the increased output will cut into the profits to such an extent as to reduce the average return on the turnover. It may be also that difficulties will be encoun-

tered in securing the additional raw material, or that a sufficient supply of labor cannot be secured at the present average price.

9. *Value of auditor's services in the case of fire losses.*—In cases of loss by fire, poorly kept financial records practically place a merchant at the mercy of the adjuster for the insurance company, while on the other hand, a certified balance sheet of the business at the end of the last fiscal period, supported by a proper system of internal records, aids the insured in securing a proper indemnity. The writer's attention was recently called to a case in which the adjuster's figures in a loss involving $50,000 were $3,000 too low, due to an improper basis of calculation on the part of the adjusters. In preparing a proof of loss, the services of a reliable auditor may prevent the business man from making an understatement of the loss he has sustained. Furthermore, if he has a fully authenticated balance sheet at the close of the previous fiscal period, certifying to the valuation of the inventory and property at that time, he is in an excellent position to insist upon receiving the full amount of his claim.

10. *Importance of audits of the accounts of employes under financial bond.*—When application is made to a bonding company for a fidelity bond, the company usually asks whether or not the accounts of the employe are periodically audited. If an affirmative answer is given, the bonding company may assume that this practice would be continued and would therefore enter into the contract. Neglect on the part

of the insured to continue the periodical audit of the accounts of the trusted employe might be used by the insurance company as a defense against the payment of the policy in the event of a claim for indemnity. Where the accounts of employes are periodically audited, there is usually no difficulty in securing a fidelity bond from any reliable bonding company.

11. *Proprietor requires an impartial review of business conditions.*—Many business men are unfamiliar with accounts altho they may have a capacity both for organization and for money-making. There are other instances of men who are in such close touch with all the activities of their businesses that they are able to determine almost to the dollar, the amount of profit or loss that has been sustained during the period.

It is a well-known practice of credit men to "dress up" the accounts receivable at the end of a fiscal period. In some cases where a debtor has not been prompt in making remittances, the credit man will secure a note from the customer for the amount of the debt past due. There is of course a certain advantage in having the note instead of an open account because the note is a confession of judgment and the claim against the debtor may be more easily proved on a note than an open account.

The bookkeeping entry upon the receipt of a note would be a debit to notes receivable account and a credit to the open account of the individual customer. An entry of this kind resulted once in deceiving an experienced executive. A customer who owed the

firm $40,000 on open account was persuaded by the credit man to send in notes to the amount of $35,000; these notes were debited to the notes receivable account and credited to the open account of the customer, thus reducing the balance in his open account to $5,000. When the executive received a statement from the bookkeeper showing the open balances in customers' accounts at the end of the period, the account of this particular debtor was shown as $5,000. The fact that there was in the safe $35,000 of notes from the debtor was not disclosed.

A short time afterward the debtor was forced into the hands of a receiver and the executive learned to his dismay, that the firm in question owed $40,000 instead of $5,000. His experience in learning the bookkeeping effect of the receipt of a note upon the open account of a customer proved costly.

In this instance, had an audit of the accounts been made, the auditor would undoubtedly have called attention to the fact that the real standing of the debtor must be determined by considering not only the amount which he owes on open account but also the amount of notes which he has given and which are not as yet due, including also any notes received from the debtor which have been discounted by the proprietor and which have not as yet matured. The advantage of a financial statement prepared by a disinterested outsider is self-evident.

12. *Necessity of familiarity with the business on the part of the auditor.*—Whether or not the auditor

should be familiar with the particular type of business depends largely upon circumstances. While it is always advisable to secure the services of an auditor who is particularly qualified by experience in the client's line of business, it must be borne in mind that the principles of the science of accounting are the same in all businesses. Unfamiliarity with the line of business will not necessarily impair the value of the services of an auditor who may be inexperienced in the particular line. On the other hand, in special types of audits, it would be unwise to trust the engagement to one who has had no previous experience in that line of work; such, for example, a stock brokerage audit—which is a special type of work and which requires a man versed in the brokerage business.

The matter is one that cannot be decided offhand. In the majority of cases, it will make no particular difference whether the auditor has had experience in the particular line or not; lack of experience does not necessarily preclude his rendering efficient service for his client. An auditor who is thoroly competent and who has received the proper training will soon make himself familiar with the intricacies of the particular business in which his services are required.

13. *Summary of the auditor's functions.*—It will be seen that there are numerous occasions for auditing and numerous advantages to be obtained from the services of a competent auditor. It is also evident that the scope of the auditor's activity is wide. No prudent business man would think of neglecting to

make a proper provision for fire insurance, liability insurance, or burglary insurance. Yet many business men will fail to realize how vitally important it is to have their accounts properly reviewed. It is often true that a thoro audit will disclose no errors, either of commission or omission, and no tangible advantage from an audit may be apparent. Nevertheless, the expense of taking this additional precaution is so small in comparison with the loss that might otherwise result, and furthermore, the moral effect upon those employes who are placed in responsible positions is so excellent, that it is the part of wisdom for the business man to employ a competent auditor.

REVIEW

Would you favor the inclusion of an article in the by-laws of a corporation providing for the election of a cut-rate auditor by the stockholders? Would your opinion be the same if the corporation were a close corporation?

Is a banker, in your opinion, justified in requiring a certified balance sheet from a prospective borrower?

In reading the prospectus of a consolidation whose securities have just been underwritten by a banker you find a statement to the effect that Messrs. —— & Company, the auditors employed, have estimated that certain economies under the new management will result in an annual saving of $500,000. What weight would this statement have with you in influencing you to purchase these securities?

What is the scope of the modern auditor's activity?

CHAPTER III

PROCEDURE AND METHODS

1. *Advance notice to employes whose accounts are to be audited.*—Where the proprietor has no reason to suspect that fraud or dishonesty has taken place, there seems to be no reason why he should keep secret his intention of having an audit made. As a matter of fact, if the employes know of it in advance, they may be able to so arrange the work as to facilitate the task of the auditor. Moreover, if audits are to be regularly made thereafter, employes will naturally expect the auditor to appear at regular intervals.

The objection that is raised to the practice of giving employes advance notice of the audit is due to the fear that they may take steps to cover up shortages or dishonest practice. It is true, of course, that cashiers sometimes temporarily borrow funds of their employers and will endeavor to make good the shortage if it is known that an audit is about to be made.

If irregular practices prevail, there is considerable advantage in having audits made unannounced, or at irregular intervals. Some of the large corporations, having numerous branches and maintaining their own auditing staff, believe firmly in the practice of making audits unannounced, even to the local managers. The first inkling given that an audit is to take place is

when the auditor walks into the office of the branch, on the afternoon of the day preceding the close of the fiscal period, and counts the cash at the close of business.

2. *The initial step in the audit.*—On the first audit of a concern, the principal, together with probably a senior accountant who will be in direct charge of the engagement, and the necessary number of juniors and assistants, will present themselves at the client's office. If the principal thru whom the arrangement for the engagement was made is not present, the senior accountant in charge will probably bear proper credentials addressed to the management. It is no doubt true, in the majority of cases, that the first work undertaken in the audit will be the verification and count of the cash. While one of the assistants is engaged in this task, it is likely that the principal, or the senior accountant, will be engaged in laying out the audit program.

3. *First audits are usually more thoro and complete.*—The first audit of a business organization is usually more thoro and more complete than subsequent ones, because the auditor must familiarize himself with the nature of the business and local conditions. The necessity for making a thoro examination would be all the more pressing if the accounting system did not provide an adequate method of internal check. As a result of the thoro examination on the first audit, the auditor will probably be in a position to make a number of constructive criticisms, or to

suggest methods of internal check, which will materially reduce the amount of detailed work necessary on subsequent audits. If such suggestions have been acted upon the auditor at the next examination will be in a position to rely more upon the system of internal check installed and may consequently reduce the cost of the audit to his client, or else devote the time which would ordinarily be employed in laborious checking to the development of still more approved methods and practices.

4. *Audit program.*—In the process of familiarizing himself with the system employed, the auditor will probably make a list of the books of account, and such other necessary notes as to the details of the system, so that he will be in a position to intelligently supervise the work of his assistants. It will probably be unnecessary for the principal to devote his entire time to the engagement but he will leave in charge a competent senior. From time to time, either by personal visits or by scrutinizing carefully the working papers brought to him at the close of the audit, the auditor will be in a position to assure himself that the work has been correctly done.

The principal will have possessed himself of all the necessary information with reference to the system and the books of account, in order that on subsequent audits he can prepare an audit program for his assistants with very little trouble. He may secure the information by reference to the working program of the first audit.

While the verification of the cash account is quite commonly the first step in the commencement of an audit it may not always be. Indeed, no general rules or procedures can be laid down, as each case must be considered in view of the surrounding circumstances. When the principal has determined the amount of work to be performed, he will probably request that some or all of the vouchers of the period shall be arranged in such an order as will best facilitate the work.

5. *Cooperation with the auditor in his work.*—The client should provide the auditor with a proper place in which to work; not only should good light be furnished and as little artificial light as possible, but the auditor should also be given plenty of desk room for handling the books and papers. It is much better to assign, if possible, a separate room or a separate section of the office for the auditing staff. It is also desirable to secure for them a place which is not easily accessible for the office force. Experience has shown the necessity of this requirement, because clerks of the client are always more or less prone to attempt to secure access to the working papers of the auditor. This is prompted in part by a natural curiosity to see how auditors go about doing their work, and possibly a desire to secure certain information about the client's business which they could not obtain ordinarily.

Auditors are naturally very careful to guard against outsiders overlooking their papers. It will be noted that, upon the approach of outsiders, not only will

the working papers be covered but the books also placed in such a position as to be safe from prying eyes. The close approach of outsiders naturally interferes with and interrupts the work of the auditor. Therefore, every precaution should be taken to secure privacy for the auditor and his staff.

6. *Relation between employes of the client and the auditor's staff.*—The position of the auditing staff upon a first audit is quite often very trying and calls for the exercise of considerable diplomacy. There is a natural resentment on the part of some employes toward the review of their work. This attitude, however, may be largely dispelled by the courteous and cordial behavior assumed by the auditor's staff.

The presence of auditors will more or less interfere with the work of the client's office force, because on certain occasions, the auditors may wish to use a book in connection with their work when one of the client's force may need it for posting or for reference. While the auditor will always attempt to gauge his work so that it will not interfere with the current work in the client's office, yet the fact must be borne in mind that temporary interruptions must occur. It is, moreover, more economical to allow the auditors to use whatever books they need and not to delay their work. Possibly arrangements can be made whereby the auditor may have access to the books in current use for a certain number of hours during the day, and the office force during the balance of the time.

The harmonious cooperation between the auditor's

staff and the staff of the client cannot be too strongly emphasized. The disagreeable situations growing out of this lack of cooperation is another reason for urging the proprietor to select the right type of professional auditor in the first instance. A difference of a few hundred dollars in the fee to be paid for the work done is not an important matter, in itself, but if it should happen that the auditor who quoted the lower fee has succeeded in disorganizing the office force, or has prejudiced the personnel against both the proprietor and himself it becomes a matter of extreme importance.

7. *The auditor's working papers.*—The detailed work of the audit will, in the majority of cases, be performed in the office of the client. The necessary statements and reports will be made up in the office of the auditor from the working papers prepared by him in the client's office. In some instances, business men, who have not had very much experience with auditors, may object to the practice of the auditor in taking from their office the details of the business. From experience in other matters, certain clients may have lost faith in human nature, and may be convinced that they are running a grave risk in allowing the auditor to take with him certain facts and figures of the business developed by the audit.

The writer recalls, in his own experience, a case of this sort in which the client demanded the return of all working papers, and was very much excited to think that the auditor should have the temerity to

carry them away with him. To the credit of professional auditors be it said, that confidence reposed in the auditor is very seldom misplaced. The auditor has as much at risk as the client, and possibly more, if working papers are lost, or the details of a client's business are disclosed thru leaks in the auditor's office. Moreover, professional auditors are accustomed to make thoro investigation into the character and habits of their assistants. These assistants are not allowed access to the private working papers until such time as their loyalty and trustworthiness have been thoroly proved. If the proprietor has employed a reputable firm of accountants, he may rest assured that all the details of his business will be sacredly guarded. He has the further assurance that the history of the profession records but very few instances in which this confidence in professional auditors has been misplaced.

8. *Treatment of information secured thru "leaks" in the auditor's office.*—Even in those cases where it appears that information has been disclosed thru a leak in the auditor's office, the clients should use great care before coming to a final conclusion that this has been the source of the disclosure. In a recent case that came to the observation of the author, it appeared that the wife of one of the partners of a firm who was suing her husband for divorce had, in making a claim for alimony and counsel fees pending the litigation, appended a statement in detail showing the actual income obtained by her husband from the part-

nership. Moreover, the statement was an exact transcript of the personal account of the partner in the private ledger of the firm. The only persons who were known to have had access to this private ledger were the partners themselves and the head bookkeeper of the firm, an employe of many years' standing, whose honesty and loyalty were unquestioned. The members of the firm at once proceeded to blame the auditors, charging them with faithlessness, and stating that the leak had occurred only thru their office. The matter appeared to be a very serious one for the auditors concerned as they could not prove the assertions to be false. It was not until the trial of the action in court that it was disclosed how the information had been obtained. The head bookkeeper, in an unguarded moment, had left his private ledger open while he went into the factory to get some information from one of the partners, in answer to a telephone inquiry. A clerk, who knew a great deal about bookkeeping, had been bribed by the attorney for the wife of the partner, to secure a transcript of this ledger account set forth in the private ledger. The auditors were thus relieved of all responsibility in the matter, but, because of the accusation, very properly declined to have anything further to do with future audits of that firm.

Even tho the present auditor of a firm may be later displaced by another, and under conditions which perhaps may reflect more discredit upon the clients than upon the auditor, the business man can rely upon the

professional honor of the auditor and feel sure that any information gained by his former auditor will not be disclosed.

9. *The doctrine of privileged communication.*—It is to be regretted that the relations between an auditor and his client are not as yet regarded by the courts in the light of privileged communications. There is no doubt that in the near future the communications between an auditor and his client will be treated as privileged. For example, if an auditor in the course of his investigation discovered that a client was undervaluing customs invoices for the purpose of avoiding payments of duties, there is no doubt that in the present state of the law, the government would have the right, if it so desired, to prosecute the auditor as an accessory after the fact, for failing to disclose this information. The theory is that the accountant would have a duty to perform in disclosing the fact that a crime was being committed. That the accountant occupied a confidential relation to his client would be of little avail to him as a defense if the government decided to prosecute him also. Furthermore, in any litigation, an auditor would probably be compelled to answer questions, the answers to which might prove detrimental to his client's interests.

10. *Information prepared in advance which will shorten the labors of the auditors.*—Especially where the auditor is being paid on a per diem basis, the client should aid him in all possible ways in order that the progress of the work may be facilitated. This should

also be the case in engagements taken under contract, as a matter of fairness to the auditor. Thus, the auditor should be furnished with correct copies of the trial balance of the general ledger, and in certain instances with trial balances of the subsidiary ledgers. When the number of accounts receivable is large, the custom of taking off an itemized trial balance showing the names of the various customers is not usually followed. The labor involved in this operation would be very great. In many cases the practice observed is to take off an adding machine list of the open accounts and to check that total against the controlling account. In other cases, the sales, the returns, the allowances, cash credits and credits for bills receivable appearing in the individual customers' accounts, will be listed on respective lists and then totaled, and the controlling account of the general ledger reconciled in this manner. It would be manifestly impossible to furnish the auditor with a trial balance of the accounts receivable ledger, containing names and amounts of from twenty to thirty thousand accounts, nor would any useful purpose be served by it. It is, however, customary to furnish the auditor with copies of the trial balances of the customers' and creditors' ledgers, when they are prepared in detail for the use of the proprietor.

11. *Schedules of notes and investments should also be prepared.*—Schedules should be prepared for the benefit of the auditor, showing the notes receivable and payable, together with the names of the obligors, the

due dates and amounts and the rate of interest. A separate schedule of all bonds as well as stocks owned should also be prepared for the auditor. This saves him the trouble of making his own list, and he can check the actual notes receivable, or stocks or bonds owned, against the list prepared by the client. The verification of outstanding notes payable would have to be made either by communication with the holders, or if the notes have been discounted at the client's bank, the statement furnished by the bank would probably disclose the outstanding discounted notes. All monthly statements from creditors should be preserved, so that the auditor can check them against the amounts appearing in the client's purchase ledger.

12. *Bank checks and vouchers to be arranged also.* —All paid bank checks should be arranged in order as requested by the auditor, together with whatever vouchers he may have decided to check. With reference to the vouchers, some trouble may be experienced where the practice of the concern is to file them alphabetically, altho they have been entered in the purchase journal or voucher register chronologically. These vouchers should be arranged for the auditor in chronological order.

13. *The auditor's responsibility for the inventory.* —The auditor's responsibility for the inventory depends upon the contract which he has made with his clients. In any event, the client should preserve the original inventory sheets for the inspection of the auditor, so that the latter may make whatever veri-

fication he may desire as to valuation, quantity and as to the accuracy of extensions and footings.

14. *The auditor will request a bank certificate.*—If it is not the custom of the client to deposit cash daily, the cash received on the terminating date of the audit period should be deposited, and the pass book balanced. In some cases it may be advisable to have the auditor balance the cash on the evening of the last day of the period. The auditor may take the pass book to the bank to be balanced himself, or he may request his client to instruct his bank to certify direct to the auditor the balance on hand at the closing date. In addition, the auditor will request information from the bank to him direct, as to the details of any loans outstanding or acceptances for the account of the client.

15. *Special points to be noted in the audit of partnerships.*—The auditor should be furnished with a copy of the articles of copartnership. He will probably make a copy of the essential provisions in it if a verified copy of the articles is not given to him for permanent filing with his papers. Inasmuch as the articles of copartnership regulate the rights and duties of the partners to each other, it is extremely important that the audit be made in the light of any special clauses in the partnership agreement.

In numerous cases the advice of the auditor will be sought in drawing up the articles of copartnership, for the reason that he will be able to aid the attorney in having the necessary clauses dealing with

the accounting properly expressed, so as to give effect to the intentions of the partners themselves. Many lawyers are wholly unfamiliar with accounting practice and procedure. A large number of the disputes that arise in partnership affairs might have been avoided if an accountant had been consulted in the drawing up of the agreement. Even where disputes have arisen, an accountant is very often called in as an arbitrator, and his services frequently help to prevent litigation, serious dispute or dissolution of the firm.

16. *Procedure in the audit of corporations.*—On first audits the auditor will not only inspect the articles of incorporation but also the by-laws of the organization, for the purpose of seeing that the accounts reflect the intention of the incorporators and stockholders. He will always inspect the minute books to see that proper entries giving effect to the resolutions of stockholders, board of directors or executive committee have been made, and note that no entries have been made in the books of account improperly, or unsupported by a resolution of the board. The stock ledgers and stock certificate books will also be examined by him to verify the capital stock outstanding.

17. *Communication with the debtors as to the validity of outstanding balances.*—The only sure way in which the auditor may test the validity of the outstanding accounts receivable, and bills receivable, is by communication with the debtors. Business men

sometimes oppose this practice, altho the reader will probably realize that the opposition is in most cases unreasonable. The padding of accounts receivable, and the use of fictitious bills receivable, are sometimes employed to conceal dishonesty and fraud. It is usually wise to take the additional precaution of communicating with the debtors for the purpose of verifying these assets.

18. *Duties of auditors serving in capacity as witnesses.*—The auditor is sometimes a witness in court in behalf of a client. Fortunate is the client who succeeds in obtaining the services of an auditor who is also acquainted with the law of evidence. He will aid his client in countless ways in the preparation of his case, by cooperating with the attorney. He may also prepare questions to be asked by the attorney for the client on the direct examination. In fact, unless the attorney himself has an excellent working knowledge of accounts, it would be well for him to be governed by the auditor in this respect. On many occasions, attorneys have been known to muddle hopelessly the case of a client by failing to ask the proper questions on the direct examination which would enable the auditor to bring out facts supporting the contentions of his client.

The auditor occupies a different relation from that of the client's attorney in that he must always take the position that he is an impartial advocate of truth. While the auditor is not, of course, bound to disclose the facts prejudicial to his client, yet if he is asked

a direct question, and the attorney for the client has his objections to the question overruled, the auditor must disclose the whole truth and answer the question.

Unfortunately, all auditors are not agreed upon the question of ethics involved here, and we sometimes have the unfortunate example of two leading firms proving diametrically opposite results from the same set of facts. There may, it is true, be occasions when the wording of an agreement, or the interpretation of facts, can be honestly viewed from two angles. There are, on the other hand, cases that are clear beyond all shadow of doubt, and in these cases, professional accountants employed both by the client and his opponents should agree. For example, a certain well-known firm of accountants was once employed by a legislative committee to make an investigation for the purpose of proving one thing. It then subsequently accepted an engagement from parties interested in the other view, and drew diametrically opposite conclusions from the same set of facts.

19. *Procedure of an auditor taking an engagement previously filled by another.*—Occasionally an auditor is called upon to take the place of another auditor. The client must expect that the new auditor will ask why his predecessor was displaced. A conscientious professional auditor would not undertake an engagement where the only reason for the change in auditors was in order to pay lower compensation. On the

other hand, if the work of the previous auditor for any reason was unsatisfactory, or the personal relation not harmonious, there is no reason why the new auditor should hesitate to take the place of his predecessor.

The new auditor will no doubt request the client to furnish him with a copy of the last report of his predecessor. There is no objection to complying with this request. In fact, it will enable the new auditor to see the method in which the proprietor was accustomed to receive his financial statements, and enable him also to observe the character of the previous work. In light of these facts he may be enabled to render more satisfactory service than did his predecessor.

REVIEW

If you were the proprietor of a business, would you favor the practice of having audits made unannounced or not?

Why would you, as the manager of a business, cooperate with the auditor in his work?

What are the differences between the relations existing between an attorney and his client and an auditor and his client?

CHAPTER IV

CLASSES OF AUDITS

1. *Classes and types of audit.*—Long-standing custom in the accounting profession has classified the functions of the auditor under certain definite types of contracts or engagements. It is the purpose in this chapter to explain these types. Audits may be broadly classified as follows: (a) detailed audits, which are of two kinds, the completed audit and the continuous audit; (b) balance sheet audits, sometimes called examinations; (c) investigations.

2. *Detailed audits.*—A detailed audit comprises a complete examination of all the books, other necessary documents and supporting vouchers of a business organization. The term, complete examination, does not, however, imply that the auditor is to check in detail every item during the period. In a large business the magnitude of the work would render this impossible. Nor is this type of examination essential in a business where a satisfactory system of internal checking has been installed. In a small business, it is usually possible to make a detailed examination of every item and this may be advisable on the first audit, but if the volume of transactions is large, the expense involved is prohibitive. The

proprietor will do well to follow the advice of his auditor in this matter, allowing the latter every opportunity to make a preliminary survey. The auditor will be governed by his best judgment in deciding what particular phases of the record should be examined in detail and what may be passed over with less minute attention.

3. *Testing the accuracy of the work in detailed audits.*—A system of internal checking which will prevent fraud unless there is actual collusion between two or more employes, will lighten the detailed work thru the employment of the method known as "testing" when verifying the accuracy of the records. Let us consider a case where the purchase of merchandise necessitates the following steps: (1) the filing of a requisition by the head of the storeroom or the head of a department; (2) the purchase of the material by a purchasing agent; (3) the receiving of merchandise by a receiving clerk, who certifies to the quantity of merchandise received on the order; (4) the approval of the invoice by the head of department for quality, and an acknowledgment of the receipt of the material in his department; (5) checking of footings and extensions and entry in the purchase journal by the voucher clerk; (6) drawing of the check by the cashier, who enters the payment in the cash book; (7) the signing of the check by the proprietor, who has before him the invoice of the creditor supported by the requisition of the purchasing agent and the record of receipt by the receiving clerk. It will be apparent

that if the foregoing system were installed, fraud could be perpetrated only thru the collusion of two or more individuals, and there would be no necessity for a detailed check by the auditor of all the purchases of material or vouchers for expenses incurred. He would probably content himself with a detailed examination of the vouchers for several months selected at random, and if this examination disclosed no evidences of fraud or error, he would probably be safe in assuming that the balance of the work was correctly and honestly done.

4. *Danger in making tests.*—There is, of course, an element of danger in accepting such a test as final, because fraudulent entries might be made in the very months which the auditor had neglected to test. Inasmuch as the detailed audit of all of the purchase vouchers is prohibited by considerations of expense as well as time, it will usually be necessary to take this risk. The law of averages applies here as well as in other cases, and since the dishonest employe can never know in advance what particular month the auditor may select for checking, the opportunity for fraud is reduced to a minimum. The auditor will not entirely ignore the vouchers of the months which he has not examined minutely. He will scrutinize the remaining entries and endeavor to satisfy himself of their correctness. The auditor is often aided in this respect by other agencies; for example, in some branches of the meat packing industry, where gains and shrinkages in the processing of the product are

recorded, mechanical errors as well as errors in the valuation of the inventory may be easily detected. Where the volume of transactions is small, a slight error in the inventory would throw the gains or shrinkages out of line with past experience. In this manner an error of one per cent in an inventory has been discovered.

5. *Detailed audits desirable in small concerns.*—Many small firms do not feel able to employ permanently the services of a highly paid and thoroly competent bookkeeper, and find it more economical to employ an ordinary bookkeeper permanently and engage a professional auditor for the purpose of making a detailed audit. The detailed audit will result in disclosing errors of principle as well as fraudulent entries, and the small number of transactions will allow a verification of each one separately. It is not possible to lay down rules that will apply to all cases; accordingly, the proprietor will do well to leave the question of the amount of detailed work to be done to the judgment and discretion of his auditor.

6. *Completed audit.*—The term "completed audit" is used to designate an audit made covering a complete period which has elapsed since the last examination. This type of audit is sometimes called a periodic audit since it covers an entire period and the examination is made at the close of the period. Before the audit is begun, the proprietor should see that the bookkeeper has all subsidiary ledgers in balance, and that the trial balance of the general ledger is in

balance, and that the aggregate balance of any subsidiary ledger agrees with its controlling account. Locating errors in these balances is not a part of the auditor's work unless he is specifically employed for the purpose, and where the records are not in proper shape for the auditor to commence his work, he will consult with the proprietor on the method of procedure. It will usually be better to postpone the audit until the bookkeeper has located his errors.

7. *Continuous audit.*—Where a continuous audit is undertaken, the auditor will appear from time to time during the business period and make such investigations as he deems necessary. Not infrequently the auditor will be asked to attend at least once a month and make a report of progress to the proprietor. In some instances, especially where the information to be derived from a monthly profit-and-loss account and balance sheet will prove helpful, the auditor will be expected to prepare a balance sheet and a profit-and-loss statement at the end of each month. Continuous audits, however, are usually distinguished from completed audits by the fact that in the latter the auditor does not report until the end of the audit period at which time he presents a balance sheet and profit-and-loss statement covering the period, while in continuous audits he will attend as a rule, monthly, and may or may not make up a balance sheet and profit-and-loss statement each month.

8. *Advantages and disadvantages of continuous audits.*—The majority of business concerns end the

fiscal period with the end of the calendar year, and this results in considerable congestion of work in the offices of professional auditors. It is evident that if some of the work involved in a detailed audit can be accomplished before the end of the year and at a time when auditors are not so busy, the proprietor will be able to receive a verified report of his financial standing much sooner than he otherwise would. Moreover, if fraud is being practised, a continuous audit will usually result in its earlier detection, altho where continuous audits are made there is an opportunity afforded to dishonest individuals to practise fraud by tampering with the past record which the auditor has already checked. This can be guarded against by the auditor. The continuous audit also has the effect of keeping the work of the clerical staff up to date because bookkeepers realize that if they are behind in their work, a report to that effect will undoubtedly reach the ears of the proprietor thru criticisms on the part of the auditor. There is also the advantage of the moral effect which the more frequent visits of the auditor will have upon those intrusted with the duty of keeping the record or handling affairs.

9. *Completed and continuous audits compared.*—Many practitioners prefer the completed audit to the continuous audit, because the latter requires considerable extra time and labor to guard against interference with records that have already been audited. On the other hand the continuous audit serves to bring the proprietor and the auditor in closer touch.

More opportunity is afforded for consultation between the proprietor and his trusted adviser on matters of business policy, improvement in organization and better methods of handling the accounts. A consideration of the circumstances surrounding each case will enable the auditor to make the proper recommendations to his clients as to which type of detailed audit should be employed.

10. *Balance sheet audits or examinations.*—The balance sheet audit contemplates a verification of the assets and liabilities and a sufficient examination of the profit-and-loss account to satisfy the auditor that each has been correctly stated. Inasmuch as this type of audit is limited in scope, the proprietor should be aware of the fact that fraudulent entries may be made which would remain undisclosed in a balance sheet audit. The greater the volume of the transactions the greater will be the opportunity for important errors and fraudulent entries to be made and remain undetected. On the other hand, where the proprietor's principal object is to obtain a certified statement of his assets and liabilities which can be used as a basis for borrowing money from a bank or obtaining credit for merchandise, this type of audit is usually all that is necessary. Balance sheet audits can usually be safely employed where a highly organized system of internal checking has been adopted They are becoming more and more common, but the business man should realize that they are attended with some degree of danger.

11. *Investigations.*—A great deal of the practice of the professional auditor consists of investigations for special purposes. Audits should be distinguished from investigations because the former include a more or less thoro review of all the accounting records, while an investigation is confined to securing certain specific information. Where work of this kind is to be done it is desirable to prepare a written memorandum of the points to be covered so that the auditor will understand fully just what his client expects him to do, and the client will not be misled into thinking that a different kind of examination had been made. For example, an investigation might be made into the books of account of an undertaking to verify the statements made by the concern. This might be done solely from the concern's books without any attempt on the part of the auditor to verify from other records the correctness of the entries in the books. Therefore the scope of the investigation will be determined entirely by the nature of the information sought, and the circumstances which surround each individual case.

12. *Investigations on behalf of a prospective purchaser of a business.*—Ordinary common-sense would dictate that anyone who intends to purchase a business or an interest in a business should have an investigation made to verify the assets and liabilities as well as the income and expense of the undertaking. The author recalls the case of a prominent capitalist in the East who purchased for his son a small business

which manufactured a patented specialty. According to the books, the concern with a very small equipment, inadequate facilities and meager capital had succeeded in making a small profit, and it was believed that with the introduction of more capital and modern methods of management, the business could be made exceedingly profitable. The sum of $250,000 was advanced by the capitalist, and at the end of the first year there was a loss from operation. The capitalist then employed a firm of auditors to instal a cost system which soon revealed the fact that the process was expensive and resulted in irrecoverable losses of considerable quantities of copper. The cost system proved that under the present methods of manufacture, the business could never be made to pay.

Notwithstanding the report of his auditors, the capitalist allowed himself to be persuaded by his engineers that the cost system was wrong, and continued operations for another year, putting in additional capital, with the result that the operations at the end of the second year showed an increased loss. The business was finally wound up after the sum of $750,000 had been wasted. In order to satisfy himself further, the capitalist asked the auditors to make an investigation of the affairs of the concern during its first year in business, for the purpose of learning why the profit which was earned in that year could not be realized in the later years. The investigation disclosed the fact that the concern at the outset of business had entered into an agreement with the

owner of the factory property in which it was doing business whereby the property was leased for the sum of $18,000 per annum. The agreement further provided that if the property was subsequently purchased, the amount paid in on rent would be applied on the purchase price. At the end of the first fiscal year, altho the option of purchase was not exercised, the managers of the concern had caused the amount paid for rent to be charged to a capital account called "factory improvement," thereby showing an item which was merely expense, as an asset and converting a deficit from operations into a small profit. Had the proper investigation been made by the capitalist before he invested the original $250,000, he would not have been deceived into believing that the business could be made profitable thru the introduction of additional working capital. In the meantime the inventor of the process, who was operating the concern at the outset, had received a good cash price for his patent rights and had recovered the amount of money that he had originally invested in the business.

13. *Investigation for receivers and those in charge of reorganizations.*—Investigations may be made by auditors for receivers or for those in charge of reorganizations to determine the cause of failure and the prospects of rehabilitation. Such an investigation might uncover unscientific methods or it might show that the failure was due to carelessness in extending credit or to lack of capital. On the basis of past experience with the information furnished by the audit-

ors, it would be possible to determine whether or not the business could be rehabilitated.

14. *Investigation for the benefit of a retiring partner.*—When a member of a firm is about to retire, difficulties regarding the disposition of his business frequently arise and may easily be the cause of serious dispute, or even litigation. It is evident that the services of a disinterested expert are likely to prove helpful in such a case. Probably there is no business relation that results in more litigation and dispute than the partnership relation, and in many instances the contending partners would be very much better off in pocket and otherwise if they selected a reliable auditor as arbitrator, rather than indulge in expensive litigation which may cause the loss of a large part of their capital.

15. *Investigation for banks.*—The banker might arrange with a prospective borrower to have an examination made, the report of which should be submitted to a banker as a basis for making a loan. Competition between banks has often resulted in the neglect of this precaution with considerable loss to the bankers. A case came to light recently in which a business concern maintaining in three banks in New York an aggregate bank balance of $1,100 had succeeded in borrowing without security from three separate banks the sum of $10,000. The corporation was a close corporation, and among the assets were accounts receivable from other corporations organized by the members of the first corporation. The receivables

were absolutely worthless; among the notes receivable appeared certain notes marked demand notes, which upon investigation proved to be notes given by a realty company, also organized by the members of the first corporation, and practically valueless as liquid assets. One of the bankers became suspicious and arranged with the borrower for an investigation before he agreed to renew the loan. It is needless to say that upon the report of the auditor the loan was not renewed.

16. *Investigations for special purposes.*—A business undertaking may enter into contract with another undertaking and there may be a stipulation that the first undertaking shall submit for audit an account of its dealings. Thus, for example, a local factor might receive consignments of Italian marble to be sold in this country, and the contract might stipulate that the shippers would have the right at any time to verify the amount of stock on hand as well as the amounts they were entitled to receive from the factor on account of sales of marble. Where a contract of this kind is entered into, it would be well for the business firm to employ an auditor to devise a set of accounts which would enable the necessary investigation under the contracts to be made without disclosing other important features of the factor's business.

A salesman might have a contract allowing him a commission on all sales made in a certain territory whether the result of personal solicitation or mail or-

ders. The contract might also contain the right of audit, thereby protecting the salesman against fraud and unintentional errors in crediting the sales made. Should the proprietor be required to submit his accounts for an audit, the auditor representing the salesman has a right to demand access to the sales record showing the distribution of the sales and to the customer's accounts in the territory reserved to the salesmen. He would also have the right to see that the trial balance of the sales ledger agreed with the trial balance of the controlling account in the general ledger, but he would have no right of access to the general ledger for any other information. Thus it will be seen that the investigation should be confined to the specific work to be covered. Where a business man has entered into contracts like those illustrated above, he should not permit the auditor for the other party to the contract to make an examination of any other records except those pertaining to the particular matter under investigation

17. *General considerations.*—It is well for the business man at the time the work is commenced to have a thoro understanding with his auditor of exactly what work is to be done. For example, an auditor might agree to undertake a balance sheet audit and if it subsequently developed that a defalcation had occurred which should have been detected by a thoro analysis of the profit-and-loss accounts, the business man might feel that the auditor was at fault in not uncovering the defalcation. As a matter of

fact, under the terms of his engagement, the auditor would not be expected to make the detailed analysis of the profit-and-loss account which would be required by a detailed audit. It is encouraging to know that the great majority of trusted employes are honest and that defalcation and fraud are not usual. It is also true that many defalcations and frauds have been uncovered thru accident rather than thru design on the part of the auditor. An experienced auditor will also have his intuitive faculties highly developed, and as the result will often detect dishonesty. Having selected the proper type of man to make the audit or investigation and having explained fully to the auditor his own ideas, the proprietor should allow his auditor to make the necessary survey and be guided to a great extent by his judgment regarding the scope of the proposed work.

REVIEW

Differentiate between balance sheet audits and detailed audits. Under what conditions would you favor each type of audit?

Do you consider that the method of test and scrutiny is justifiable? Under what conditions would you favor having a detailed audit made?

What, in your opinion, are the advantages and disadvantages of completed and continuous audits and which type do you favor?

How are investigations distinguished from audits and for what purposes are investigations made?

CHAPTER V

VERIFICATION OF THE ASSET SIDE OF THE BALANCE SHEET

1. *General duties of an auditor in the verification of assets.*—The methods which the auditor will employ in verifying the assets and liabilities of a business undertaking will be largely governed by the nature of the contract that he has made with his clients. It will also vary with conditions as the auditor finds them. Each auditor has his own methods of procedure. His report must show all the assets which the business possesses, whether they are reflected in the books of account or not. He is bound to see that the value of the assets is correctly stated, and while he is not an insurer or an appraiser, he must not certify to a balance sheet in which the assets have been overstated. The auditor must also ascertain the amount of the liabilities outstanding, whether these are stated in the books or not. If he is careful and thoro in attending to these matters, that is all a client requires of him.

2. *Procedure will depend on circumstances.*—Just what reasonable carefulness is, depends upon the circumstances of each case. Frequently the books will not disclose the true financial condition, and it is incumbent upon the auditor to discover, if possible, er-

rors and omissions. An auditor cannot, of course, be expected to discover dishonesty if the records and other available data contain nothing which would arouse his suspicions.

He must, above all, be honest; he must not certify to that which he does not believe to be true. But if there are no suspicious indications, very little inquiry on his part may be all that is necessary. On the other hand, while it is his duty to ascertain and state the true financial position of the company or undertaking at the time of the audit, and while he can do this only by examining the books of the company, yet he does not fully discharge his duty merely by performing the examination.

3. *Auditing before a balance sheet is prepared.*—For illustration, an auditor may reasonably assume that an individual will not conceal any of his assets if his accounts are being audited for the purpose of preparing a balance sheet to be submitted to a banker as the basis of a loan. The prospective borrower may overstate his assets, or he may represent that the assets are free from liens when such is not the case. The prospective borrower may also understate his liabilities. Hence the auditor, in an examination of this kind, would be on his guard particularly against an overstatement of the assets and the concealment of liens and liabilities.

It is the intention in the present chapter to discuss briefly the methods which the auditor will ordinarily

employ to verify the assets and liabilities of a business.

4. *Verification of cash in hand.*—The auditor will verify the amount of cash in hand by actually counting the cash. When notice has been given to the employes that an audit is to be made, the auditor may not satisfy himself with merely counting the cash at the beginning of his audit. If he learns of suspicious circumstances, he will probably count the cash again at a later date. If the amount of cash in hand is greater than is needed to meet the demands of the business, he will probably call the attention of the management to this fact.

If the cash is counted on a date subsequent to the terminating date of audit, the auditor will probably audit the petty cash book up to the date when the audit is begun, and verify the cash at that date, first, in order to see that it agrees with the balance shown in the cash book, and secondly, for the purpose of establishing the correctness of the balance at the close of the audit period. When cash funds are in the hands of several individuals, the balances should be verified simultaneously, so as to prevent the same cash being produced twice as representing balances in the hands of several persons.

All I. O. U.'s in the cash box should bear the approval of some responsible authority; checks of employes for large amounts exchanged by the cashier for cash, and cashed for the convenience of employes,

may require special consideration. Due-bills and advances are not cash. If any were on hand at the terminating date of audit period, or if payments were made for expenditures out of petty cash which had not been charged to appropriate expense accounts at the date of the audit, the auditor must make the proper adjustments in the accounts.

5. *Cash in bank.*—The asset, cash in bank, may consist of cash deposited on current account, of cash in restricted funds, or of certificates of deposit. The auditor will probably request the management to write to the several depositaries, asking them to certify, directly to the auditor, the amount of the various balances on hand on the date the audit is closed. In addition, the banks will be asked to certify to the amount of acceptances and notes-payable outstanding. The certificates of deposit will be inspected, and the accrued interest up to the date of audit will be calculated and will be shown as an asset.

When a business undertaking contemplates having an audit made as of a certain date, the bank pass-book should always be sent to the bank to be balanced as of that date, and all cash which is collected on that business day, and which has not yet been deposited, should immediately be deposited.

6. *Should the auditor check all footings?*—The question will be raised, whether or not the auditor should check all the footings in the books of original entry and in the ledger accounts. It must be admitted that fraud and dishonesty have sometimes been

perpetrated thru manipulation of the footings in the books, and yet considerations in regard to time and expense may prohibit verification of the footings of all the books. The problem is comparatively simple if an adequate system of internal check has been installed. Some auditors insist upon checking the accuracy of all footings, both in the books of original entry and in the ledger accounts; while others believe that complete verification is unnecessary, and that the time required for such operations should be spent upon other phases of the work.

It is evident that footing the cash book would neither prevent nor detect the fraudulent holding out of cash by a dishonest cashier. He could either make no entry of the money, or postpone making an entry until a later date; in either case he could make use of the cash. Most auditors would probably check all disbursements shown in the cash book, item by item, against either the bank vouchers or the canceled checks. In the end, the auditor himself must decide what method to adopt. It would seem that the checking of footings is not all-important, since falsification of footings is, in the majority of cases, the crudest attempt at fraud; if an employe is really dishonest, he can use any one of many other safer ways to accomplish his end.

7. *Checking the postings.*—The question as to whether all postings should be checked or not is also debatable. Some auditors insist on checking the accuracy of the posting by analyzing the ledger. At

times this would seem advisable since not only may mechanical errors in posting occur which will materially affect the account, but fraudulent postings may be made.

With reference to the cash book, if all cash receipts are deposited in the bank, and all payments are made by check, the footings of the cash book can be proved by simply checking the bank's receipts of cash deposited and its records of cash paid out.

When columns are provided for cash sales or other items of income, as well as a column for discounts allowed on the payment of accounts receivable, a cashier may defraud by underfooting the columns in which the receipts of cash are entered and overfooting the discount or other credit columns. Where this possibility seems to exist, the auditor will probably check the footings of these columns. Probably the postings to the nominal accounts will be checked and the analysis of the sundries column will be tested.

On the payment side, probably all postings should be checked, but even this check is not sufficient to reveal all the fraudulent entries that could be made. For instance, a check might be abstracted from the check book and might be drawn to the order of the cashier or someone in league with him; it could be destroyed when it was returned canceled from the bank. The footings on the payment side of the cash book would be forced to cover up the amount abstracted. The testing of the footings on every fourth, fifth or tenth page of the cash book would not, of

course, uncover the fraudulent footing if the footing of the page upon which it occurred were not also verified by the auditor.

Thus we see the difficulty of attempting to lay down rules applicable to all possible cases and conditions. An experienced auditor can generally be relied upon to sense the particular situation and determine which items he may safely omit and which he must check in detail when a complete verification is not possible.

8. *Verification of purchase-journal entries.*—The principal danger in connection with the purchase journal is that the entry of fraudulent overcharges or credits to fictitious vendors may pass undetected. The auditor should probably check the postings of the debit columns of the purchase journal but he will have to do more than this to discover credits to fictitious vendors or overcredits. It will probably not be necessary, however, to check very thoroly the individual credits to the accounts of the vendors.

Some verification of the individual vouchers supporting the entries in the purchase journal must be made for the purpose of detecting possible fraudulent credits or overcredits or duplicate entries of purchases or expense. Here again, if an adequate system of internal check has been installed, the work will be simplified.

9. *Methods to be used in checking sales journal.*—Fraudulent sales transactions are often made by omitting to enter sales in the salesbook and abstracting the

cash when the customer makes remittance. The sales clerk frequently practises this kind of fraud in collusion with a clerk in the shipping department. If the fraud is great it will generally be revealed either by a discrepancy in the book inventory or by a reduced profit on the turnover. But when the volume of business transactions is large, a small theft is not easily detected Probably the monthly aggregates of sales postings should be checked, considering the fact that fraud is often practised in the handling of cash sales—that is, the sales clerk will purposely not record them. Sometimes, too, fictitious sales returns or sales allowances are entered in the books.

In conclusion, it will be seen that the only absolutely safe method to pursue is to check and verify every individual entry in the record. But as this is in so many cases a physical impossibility, and furthermore, is often precluded on account of the time and expense, recourse must be had to the method of test and scrutiny. Reliance must be placed, to a great degree, upon the system of internal check and upon the ability of the experienced auditor to scent the weak spots in the system, and the suspicious circumstances as they arise.

10. *Verification of the accounts receivable.*—The assets of accounts receivable should be classified on the balance sheet according to whether they are due from trade debtors or from others, such as officers, employes and stockholders.

The amount due from the first group may be veri-

fied by mailing to the trade debtors a statement of the amount they owe, with a request that they mail a confirmation statement, properly signed, directly to the auditor. There is, however, a great deal of prejudice against this method among business men, and for this reason the auditor will usually have to use other means of proving the accuracy of the amounts outstanding.

In connection with his examination of the accounts receivable, he will take note of any accounts that appear to him to be bad or doubtful. In certain instances, he will prepare a schedule of the open accounts, classifying them according to age. In many cases, however, this will not be practicable; if it is not he will probably rely upon his experience to determine whether the amount of the outstandings is normal, and whether or not, based upon the past experience of the particular business, the amount bears a proper relation to the sales. He must also be on his guard to discover any fictitious accounts receivable or any long overdue balances or partly paid amounts in the accounts of debtors, which may cover up defalcation.

His investigation may disclose lax methods in the collection department, which he will call to the attention of the management. Salesmen and credit managers are prone to overvalue the accounts of slow payers, and it is the auditor's duty to see that an adequate reserve is provided against losses on these accounts. Each business must be considered by itself

in connection with the surrounding circumstances, when an auditor is forming an opinion as to the value of the book debts.

When a concern has been in business for a number of years, it will probably be possible to make adequate provision for the reserve for bad debts, based upon a certain percentage of the sales or of the outstanding accounts. If the auditor cannot rely upon past experience of the business concern he is investigating, he either may create an adequate reserve based upon the experience of other concerns engaged in a similar line, or he may make such other provision as his judgment dictates.

11. *Sales on approval and their treatment.*—The auditor will eliminate from the amount shown as being due from trade debtors, charges made to customers for goods sent out "on sale or return," "approval sales" or "goods shipped on consignment." These should be taken out of the amounts shown to be due from trade debtors and they should be deducted also from the sales of the period. The cost price of the merchandise, awaiting sale in the hands of others, less whatever amounts it may be necessary to deduct for depreciation or for deterioration, will be added to the inventory.

12. *Debts due from officers, stockholders and employes.*—Amounts due from officers, stockholders or employes will be verified by securing an acknowledgment of the debt, and by such examination of the records and other data as may be necessary. Amounts

due from stockholders for subscriptions to stock on the partial payment plan may be verified by communication with the debtors, or by an examination of the records to see that the amounts which the subscribers agreed to pay have been paid according to their contracts.

13. *Verification of individual ledgers with controlling account.*—The auditor may properly decline to give a certificate as to the validity of the outstandings unless he has compared the amounts in detail with the customers' ledgers and confirmed them in such a way as thoroly to satisfy himself in regard to their validity. In some cases, this rule may be modified when a proper system of internal check has been employed by the firm, and when the practice of the concern has always been conservative. For illustration, let it be assumed that in a concern selling goods on the instalment plan, the auditor found that the practice was to transfer to the doubtful-accounts ledger all accounts the payment of which was a definite number of days overdue. Let it also be assumed that it was the custom to transfer from the doubtful-accounts ledger to the bad-debts ledger, all accounts that had failed of collection where ordinary collection methods had been employed. The auditor, in this instance, might reasonably rely upon the fact that the accounts which the concern shows as good are actually worth their full amount.

14. *Advances to subsidiaries.*—Advances to subsidiary companies may not be current assets. The subsidiary may have used the amount advanced for

construction purposes or even to make good certain losses on current operations. Therefore, such advances must be traced into the accounts of the sub-companies if their true character is to be determined.

15. *Inspection of bills and notes receivable.*—The auditor will actually inspect the bills and notes receivable which make up the amount appearing in the bills or notes receivable accounts. He should make an investigation of the character of the bills and notes; that is, he should determine whether they are instruments drawn in the ordinary course of trade or whether they cover special advances of funds not in the ordinary course of business. He should see that they are properly made out and that none are overdue. Overdue bills or notes are subject to the same treatment as overdue accounts receivable, in that an adequate reserve against the possibility of their ultimate non-payment must be provided for. Each individual note must be valued upon its own merits. Where bills and notes receivable fall due between the terminating date of the audit and the completion of the engagement, the auditor will probably trace the bills thru the cash book to see whether or not all have been paid.

In connection with his examination of the bills and notes receivable, he will determine the amount of the contingent liability of the undertaking as regards bills which have been discounted, and which have not as yet matured. This contingent liability for unmatured discounted bills of customers may have an important

bearing upon the future of the concern if the makers should fail to pay at maturity.

Fictitious bills and notes receivable are often used to cover up defalcations, and the auditor should bear this in mind in carrying on his process of verification.

16. *Proving the accuracy of inventory values.*—It is unfortunately true that in the great majority of balance sheets published, inventory values are the asset to which the auditor cannot certify unqualifiedly, either because he was not present at the time the inventory was taken, or because it was not taken under his supervision. It may also happen that the audit is taken so long after the inventory that an accurate checking of the quantities on hand at the end of the audit period will be impossible. While the auditor in almost every case is forced to accept a certificate as to the quantity, and in certain cases as to the valuation of the inventory, from one of the company's responsible officials, yet this does not free him from the responsibility of seeing that the asset is not overstated.

The auditor will probably call for the original inventory sheets to see that they are initialed or otherwise certified to by the persons who took the stock. He may satisfy himself that the individuals who took the inventory were competent to do so, and that they appreciated the importance of their responsibility. He may also test the validity of the prices at which the inventory was extended, by a comparison with recent

invoices, or by reference to trade papers. To a certain extent he must also verify the extensions and footings of the inventory. He can also see that the rate per cent of gross profit on the turnover agrees reasonably well with the rates of preceding years.

The auditor must make a sufficient examination to see that goods received on consignment or "on sale or approval" are not included in the inventory. It will be necessary, too, for him to note whether any goods were included in the inventory for which payment was not made, or the liability for which was not entered in the accounts at the date of the audit. A large increase or large decrease in the amount of stock on hand would also call for some explanation, and the auditor would have to determine the cause of the increase or the decrease. Even tho he is not assuming any responsibility for the inventory, and even tho he properly protects himself by a suitable qualification in his certificate, it is always well for him to see that the inventory is not overstated. It is very easy for a dishonest management to manipulate the inventory. If the organization maintains a perpetual book inventory, the materials on hand may be actually counted and the results may be compared with the book inventory. By making such a test the auditor may prove in a general way the accuracy of the stock-room records.

17. *Securities and investments should be examined.*—Stocks and bonds owned, mortgages receivable and other securities will be verified by actual inspection.

These documents may represent temporary investments of cash surplus or permanent investments, constituting sinking or other special funds. The auditor will see that the securities stand in the name of the owner, and that evidences of debts held are not overdue. In the case of mortgages, he must determine whether there are any fictitious or canceled mortgages, which may be submitted to him as genuine assets. Where securities of this kind have been purchased during the period under review, he may verify them by correspondence, by inspection of the broker's notices, and also by an examination of the securities themselves.

18. *Verification of real property owned.*—The auditor will probably obtain the title deeds and make an inspection of them. The danger here is that tax liens or mortgage liens against the property may not be disclosed by the books. The auditor will satisfy himself upon these points either by requesting the management to have a proper title search made and have the results certified to the auditor, or by himself taking the initiative and having a search made. Tax bills are sometimes a good guide to title, altho, of course, the property may have been disposed of since the tax was assessed, and the cash may have been received and not recorded.

When property is mortgaged, a statement should be obtained from the mortgagee as to the amount of the mortgage. Verification of the purchase of property during the period under review can also be made

by seeing the check made out to the vendor in payment and noting whether or not it is properly indorsed. The examination of correspondence files, too, will help to verify the purchase price. If the undertaking is a corporation, the minutes of the board of directors should show a resolution authorizing the purchase of the property.

19. *Verification of plant and machinery.*—When the auditor verifies plant and machinery, he must see that items of repairs and renewals are not charged to the capital accounts. He should also make sure that machinery leased is not capitalized by charging the rental to an asset account. In fact, an analysis of all the property accounts should be made in order to ascertain the character of the items that compose them. The question will sometimes be raised, is the auditor responsible or not for the valuation of assets purchased prior to the period of his audit? The answer is, that the auditor will probably make a sufficient examination of the past transactions in the capital account to satisfy himself that fictitious assets are not included and that inflation has not been resorted to.

The auditor, as has been pointed out above, is not a valuer or an appraiser, and yet he must see that the valuation of fixed property assets is not overstated in the balance sheet, and that the proper provision for depreciation has been made. In some cases his work will be simplified considerably if an accurate record of the plant and machinery as well as of buildings has been kept. In regard to the provision for depreciation, if

the auditor has had experience in concerns like the one whose accounts he is examining, he may rely upon his experience in determining whether or not the provision for depreciation is adequate. Of course the most satisfactory method is to have an appraisal made, but this is out of the question in the majority of cases. Any equipment purchased during the period under review, or any furniture or fixtures purchased during the audit period may be verified by noting whether or not the invoices of the vendors are properly authorized by the management, and by examining any contracts made for installation.

20. *Valuation of intangible assets.*—With reference to patents, copyrights and trade-marks, the auditor's main concern is to see that they are not overvalued, and that adequate provision has been made for their depreciation. He must also see that the rights have not been assigned or disposed of. If the amounts debited to patents, trade-marks and good-will have been used to conceal an issue of watered stock, the auditor will insist upon giving the account a new name that will indicate the actual facts.

Patents can be very accurately valued in the great majority of cases, and copyrights can be valued upon the basis of their earning power. The use of a trade-mark results very often in the creation of good-will, and while the author does not approve of the arbitrary creation of good-will upon the books of a going concern, nevertheless, there are many cases in which corporations have capitalized the good-will of a trade-

mark, have issued common capital stock against it, and have consistently paid dividends out of earnings on these stock issues. In any event, the facts should be clearly set forth by the auditor in his report. He will not certify to a balance sheet in which the intangible asset, good-will, is merged with the tangible assets of plant and property. Such action on his part would be misleading and therefore reprehensible.

21. *Verification of deferred assets.*—It will not, as a rule, be difficult for the auditor to verify the accuracy of the items which are shown under the caption of deferred assets or deferred charges to operation. These will comprise such items as interest paid in advance, organization expenses, and unexpired insurance premiums. The auditor will examine insurance policies, note the property covered, and compare the amount of insurance carried with the valuation of the property insured, to see whether or not adequate insurance is provided on both the fixed and the movable property of the corporation. He will then calculate the valuation of the unexpired insurance premiums in order to be able to state them as an asset in the balance sheet.

Discounts or interest paid in advance will be verified in connection with the investigation of the obligations upon which these items depend. With respect to organization expense, the auditor will see to it that only items which are properly chargeable to this account have been charged to it. Losses on operations should not be charged to organization expense.

22. *Sinking fund, cash and investments.*—The au-

ditor will verify the amount standing at the debit of these accounts by examining the actual securities and verifying deposits, if the sinking fund created is in the hands of the debtor corporation. In the majority of cases, however, the sinking fund and its management are placed in the hands of a trust company acting as trustee. The auditor will fortify himself by securing from the company a certification of the state of the funds, showing the securities contained therein and the amount of cash. In certain instances bonds of the debtor corporation are purchased out of the sinking fund. In this event, the auditor must verify the actual existence of bonds of this character, if they have been allowed to remain alive; or if the bonds have been canceled, he must verify that fact, and must see to it that proper precautions have been taken to prevent the illegal use of these instruments.

23. *General rules as to verification.*—The foregoing outline sketches the practice of the auditor in regard to the verification of the assets mentioned. The principles to be employed in the valuation of them are discussed in the Text on "Financial and Business Statements." In brief, the auditor must make such examination as will reasonably prove that the assets shown by the books are in actual existence, and that the title to them vests absolutely in the undertaking whose accounts he is auditing. He must also see that all liens and hypothecations are set forth. Some business executives may have a tendency to resent the searching investigation that the auditor must make.

But they should realize that the auditor makes himself liable in law to a client who suffers a loss thru the dishonesty of an employe, if it can be shown that the auditor performed his work in a careless and negligent manner, and that the error was one which the auditor should have discovered.

The auditor who carelessly or fraudulently certifies to a balance sheet when he should not do so, may possibly be held also liable to an individual who, relying upon the auditor's certification, was swindled in an enterprise. The business executive should not regard as any reflection upon his own honesty the thoro verification of the assets which the auditor insists upon making, nor should he think that the auditor is doubting his word. In fact, the thoroness with which the auditor checks such information as he may obtain from the business manager and from the accounts, is merely an indication that he is working for the best interests of the concern.

But the auditor is often perfectly safe in relying upon the statements of the business executive without specially verifying them, or at least he is often justified in verifying them only in a general way, altho no general rule can be laid down. The matter is one which must be decided by the auditor himself; he must rely largely upon his intuition and experience when brought face to face with actual conditions.

REVIEW

What in your opinion would constitute a proper investigation on the part of an auditor engaged by you to verify cash in bank and on hand?

In arranging a definite program of work with your auditor, would you consider it advisable to provide for a thoro check of postings and proof of footings? If not, to what extent would you limit his work in this respect?

What procedure would you expect your auditor to follow in his verification of inventories if you requested him to furnish you with an unqualified certificate?

What should be your attitude, as an executive, toward the professional auditor you have employed, when answering questions he may put to you about the details of your business?

CHAPTER VI

VERIFICATION OF LIABILITIES

1. *Liabilities to be verified.*—In the matter of verifying the liabilities the auditor's duty consists in ascertaining whether or not all liabilities are stated, and whether or not those that are shown are properly liabilities of the undertaking.

Some business undertakings make large purchases of raw materials in the current period which are to be manufactured into finished goods in the following period. Inasmuch as the raw material is purchased for the next business period, many business men contend that the amount of such purchases if unpaid for should be eliminated both from the inventory on hand at the close of the current period and from the current payables. This contention is advanced especially if the goods have been purchased at advantageous prices and if the payment will not be due until some time in the future.

An auditor cannot accept this view, because if the title to the merchandise vests in the undertaking whose accounts he is auditing, the amount due to the vendors is a valid liability and must be so stated in the balance sheet which he prepares. While the inclusion of these items in the balance sheet may disturb that favorable

relation between current assets and current liabilities which a banker or a lender of funds expects to find, it is possible to explain to the banker the reason for the apparently unfavorable showing. If the merchandise has been purchased on advantageous terms and if the quantity on hand is reasonable, an intelligent banker will make allowances therefor.

2. *Procedure in verifying outstanding accounts payable.*—The only sure method which the auditor may employ in determining whether or not the amount of the liabilities outstanding at the date of the audit is correct, is to secure confirmation of the amount from the creditors themselves. The auditor may also make an examination of the correspondence files from which he may extract information to aid him in determining whether or not all of the outstanding obligations have been taken up in the accounts.

Very often, either by design or by accident, the total amount of liabilities due at the end of a period is not stated. An auditor was recently requested to make an audit of a retail grocery store for bank "A," to which an application had been made for a loan. The grocer was doing business with another bank "B," but had succeeded in borrowing money on one note from bank "A," altho he had no account at the latter bank. The records of the grocer were kept by single entry and after making a thoro analysis of the records and such other data as he could obtain, the auditor made up a statement of the assets and liabilities of the grocer which he presented to the officers

of bank "A." The latter bank, however, had not informed the auditor of the outstanding note held by it, and when the balance sheet was presented to the cashier, it did not disclose as a liability the note held by bank "A."

When the auditor was informed of this, he made a further investigation to determine why the records of the grocer did not disclose this note. The auditor found that the loan was originally made at a date considerably prior to the audit period, and that it had been renewed several times. When the proprietor renewed the note, he paid the discount on each occasion to the bank in cash, and the amounts withdrawn from the business in cash appeared in his cash book as tho they were ordinary drawings of the proprietor and were so considered by the auditor in making his investigation.

In this case, the auditor had used what might fairly be considered reasonable care and prudence in ascertaining from the records the existence of all liabilities. Furthermore, there was nothing in the records which he examined that would cause him to suspect that another note was outstanding. The grocer was also free from blame because he did not handle the transactions in this way with the intention of deceiving.

Another case in point is furnished by a concern whose records were kept by single entry. This concern negotiated a loan at a bank out of town. The check transactions with the out of town bank were carried in a separate check book and did not appear

in the cash book or other records of the undertaking. The check book on the out of town bank was not presented to the auditor at the time that he called for all the concern's records. Here was a deliberate attempt on the part of the firm to withhold information from the auditor and to cancel an outstanding liability.

While it is not possible as a rule, for the auditor to have access to the incoming mail to uncover any liabilities that may not be disclosed by the books at the closing date of his audit period, he is under obligations to make such other independent investigation as is necessary in order to arrive at the amount of the outstanding debts. The auditor will probably check the statements received from creditors at the first of the month against the open balances appearing in the ledger accounts. However, there will be some cases where reliance cannot be placed upon this method of verifying the outstandings, as there are some business houses which do not send statements to debtors every month.

An inspection of the records of the receiving department may disclose receipts of merchandise that were taken in the inventory, the liability for which has not been set up on the books. If the amounts are small and relatively unimportant, the auditor will probably ignore them. On the other hand, if they are large, the auditor must include them both in the inventory and among the liabilities.

3. *Other liabilities that may be omitted.*—If the final date of the audit period falls in the middle of a

week, the auditor must accrue that portion of the week's payroll which falls within his audit period. This also applies to salaries and commissions. He will also probably go thru the ledger expense accounts for rent, taxes, heat, light, etc., in order to see that all amounts due for current expenses of this character have been entered and charged to the expense accounts up to the date of the balance sheet. If interest has accrued on overdue accounts payable, he will include the amount of such interest as a current liability in his balance sheet.

4. *Procedure in the verification of notes payable and acceptances outstanding.*—Notes payable are of two classes; those which are issued with collateral supporting them and those which are issued without accompanying collateral. Where a note has been secured by a pledge of collateral, the nature of the collateral should be specified in the balance sheet. The collateral security may consist either of a pledge of assets or the deposit of unissued bonds. In some cases it will be found that notes are given to creditors in payment for goods bought for which no entry has been made in the accounts altho the goods themselves have been included in the inventory. Notes are occasionally given for the accommodation of others and a record of them may not appear in the books. These liabilities are very difficult to trace and in many cases are discovered only by accident. However, the auditor's experience will often enable him to discover some clue to the existence of undisclosed liabilities.

The interest accrued on all loans and notes up to the date of the balance sheet must be charged to the appropriate expense accounts of the business, and the liability therefor expressed in the accounts. In his examination of the profit-and-loss account, the auditor will scrutinize the expense accounts and also the outstanding expenses, in comparison with those of previous periods in order to see whether or not any large difference exists in the amounts. Correspondence or bills from attorneys may show that the concern is involved in litigation, and this fact may possibly render necessary the creation of a reserve against the contingency of an unfavorable outcome of a pending suit.

5. *Examination of public records.*—The auditor may find it necessary to consult the public records in order to verify mortgages outstanding. He may also communicate with the creditor to verify the amount of the mortgage and the interest dates as well as the due date, and to note the security underlying the mortgage. Communication with the creditor would also disclose whether or not payments alleged to have been made in reduction of the amount of the mortgage have actually been made.

From an examination of the public records, judgments against an organization may be revealed. Judgments are rarely recorded on the books of the debtor until they are paid. There may be other liens against the real property, such as assessments, overdue taxes or water rates, all of which may be determined by a proper inspection of the public records.

The auditor will have to use his own judgment in each individual case to decide whether or not he must consult the public records to verify the amount of such outstanding obligations.

6. *Verification of bonds outstanding.*—There is usually little difficulty in determining the liability of a corporation for mortgage or debenture bonds outstanding, because of the safeguards which the bondholders themselves have provided against the fraudulent overissue or misuse of these instruments.

In connection with sinking funds created to retire mortgage debts, the auditor must read the indenture and see that all the provisions to which the obligor agrees under the contract have been carried out. The auditor must also see that all interest accrued, even tho not as yet payable, on all bonds outstanding, appears in the proper place in the accounts.

7. *Service liabilities outstanding.*—Some business organizations receive payments in advance on account of sales or services which they agree to render. For example, a restaurant may sell commutation tickets, or a railroad may have outstanding service liabilities for transportation. In some cases, the determination of the amount of the outstanding service liabilities is a difficult matter. Trading stamp and premium companies are other examples of concerns which have outstanding liabilities of this character. The failure of purchasers to take advantage of the service or to redeem coupons, or the failure to use portions of railway tickets will result in a profit. The auditor must be

on his guard to see that the full liability outstanding for undelivered service of this nature is provided for in the accounts, or that improper credit has not been taken in the income account for lapses or failure to redeem coupons or tickets.

8. *Liability on uncompleted contracts.*—A business undertaking may enter into a contract agreeing to receive a certain quantity of raw material at certain specified dates in the future, payment to be made either upon delivery or upon a specified date after delivery. If the effect of these contractual obligations is ignored in preparing a balance sheet, bankers, stockholders or creditors may be deceived. The auditor must therefore make an investigation to determine first the amount of these unfulfilled contracts; and second, the nature of the liability of the concern under the various contracts. In light of these considerations, he will be able to determine whether or not mention of them should be made in the balance sheet. If the contracts are such as are taken in the ordinary course of business, and if they will not materially affect the financial standing of the undertaking, they are usually ignored.

9. *Liability for containers or returnable packages.*—It is the custom in certain lines of business to allow customers to return containers which were charged to them at the time the goods were shipped. The containers may be returnable at any time at the option of the customer, or there may be a time limit fixed for their return. The auditor should satisfy himself that

the amount of the liability set up for containers which are returnable is adequate.

10. *Auditor's duty regarding reserves.*—The auditor will determine whether or not the amount set aside as a reserve for depreciation of fixed or working assets is sufficient to meet the depreciation actually sustained, and whether the reserve for bad debts is adequate for the possible loss on doubtful accounts and notes receivable. An auditor must have breadth of view, and if he finds upon consultation with his clients that his own estimate for depreciation or for doubtful debts has been made in excess of the actual requirements, he should alter the amount of his provision. On the other hand, the client must bear in mind that the auditor does not always know the purpose for which his balance sheet may be used, and for this reason he is apt to err on the side of conservatism. If a client has failed to make proper provision for all contingencies and will not agree with the auditor's estimate of the amount necessary to be reserved, the auditor may allow the client's figures to stand altho he will be in duty bound to qualify his certificate and state his opinion as to the inadequacy of the amount reserved.

11. *Verification of capital stock outstanding.*—The auditor will examine the certificate of incorporation of a company as well as its by-laws and minutes. He will note how the stock was paid for. He will make such inquiry as may be necessary to determine whether the proper procedure has been followed as indicated

by the resolutions of the board of directors or stockholders. He will also examine the stock certificate book and stock ledger to make sure that no overissue of stock has been permitted, and he will trace the proceeds of the sale of stock into the assets. It should be noted that no audit would prevent a dishonest corporate official from raising the amount of a certificate from that indicated in a stub, and using the certificate as the basis for bank loans. This form of fraud has been perpetrated.

The foregoing covers in a general way the procedure which an auditor may be expected to employ in the verification of the liabilities and capital outstanding of a business organization. The auditor will not only use the books of account in his examination, but should also have access to any other data and memoranda such as contracts, minute book, memoranda of agreement, or correspondence, in order to enable him to assure himself as far as possible, of the accuracy of the statement which he is expected to certify.

REVIEW

A company dealing in chemicals has entered into a contract for the purchase of 50,000 tin cans of assorted sizes to be delivered during the ensuing year. Should the liability of the company under this contract appear in its balance sheet?

How may an auditor satisfy himself that the amounts stated in the creditors' ledger comprise the total outstanding payables of a business organization?

What investigation would you expect an auditor to make in verifying the capital stock account of a corporation?

An auditor differs with a client as to the amount to be provided as a reserve for possible loss on outstanding accounts of

trade debtors. If the differences of opinion could not be reconciled, how would the auditor proceed?

Would an audit of the stock ledgers and stock certificate book uncover all fraud that might be perpetrated in connection with stock issues?

CHAPTER VII

REPORTS AND CERTIFICATES

1. *Contents of auditor's report.*—When the auditor has completed his investigation of the books and accounts of his client, he usually prepares in his own office a report of the result of his examination. Each auditor will have his own method of preparing this report. All reports are alike to the extent that in balance sheet audits a balance sheet will be submitted. If the audit is a detailed audit, a profit-and-loss statement will also be prepared. Both statements will be supported by such schedules as the auditor deems necessary. The report will include comments on those matters which the auditor deems necessary to bring to the attention of his clients. The nature and the character of the comments will be largely determined by the nature of the contract which the client makes with his auditor.

The certificate of the auditor will also be included, either on a separate sheet or typed upon the balance sheet. The client should arrange beforehand with the auditor for the number of copies of the report which he desires. Thus, in the case of a partnership, each partner should receive a copy of the auditor's report. A client might also request additional copies to submit to his banker.

2. *The scope of the auditor's report.*—The contents of the auditor's report will ordinarily deal only with matters relating to the accounts. As a rule, if the client has not specifically requested it, the auditor will not criticize the system unless it is inadequate or devoid of necessary internal checks. Even in this instance, he will probably do nothing more than suggest the advisability of a change, leaving it to the client either to pursue the matter further or to leave the system unchanged.

3. *The right of an auditor to make suggestions and recommendations.*—In so far as methods of accounting are concerned, the auditor is entirely within his province in making suggestions and recommendations. Suggestions or recommendations on matters of business policy or organization are beyond the scope of the auditor's work. Nevertheless, it often happens that a client will value the good judgment and business ability of his confidential adviser to such an extent as to welcome suggestions or criticisms, both as to matters of business policy and as to internal organization. If advice of this character is given by the auditor, in most instances it should be given orally, as it does not properly form a part of an auditor's report.

4. *Eliminating extraneous matter from an auditor's report.*—The importance of the elimination of extraneous matter from the auditor's report will perhaps be better realized when it is considered that one of its most significant uses is as the basis of a bank loan.

Hence, suggestions or recommendations for changes in system or internal organization may well be made the subject matter of a special report.

5. *Auditor's mistakes in preparing reports.*—Business men sometimes justly criticize the reports of an auditor because the latter has not written it with special reference to those to whom it is addressed. It is clear that a report to a client who has no knowledge of accounts should be free from technical terms. The statements accompanying the report should be prepared, not with special reference to the accounting technique, but in such a way that a layman could easily understand them without having had any knowledge of debits and credits.

Some auditors, also, fall into the mistake of making their reports too cumbersome, reporting uninteresting details which the business executive has neither the time nor the inclination to consider. This type of auditor utterly fails in his mission, and he cannot blame the business man if the latter does not engage him for a subsequent audit. Many times the business man has called in another accountant, and asked him to audit the books again and prepare a report which he could understand.

6. *Restrictions placed by auditors on the use of their reports.*—Some auditors have felt the necessity of forbidding the public use of their reports and certificates, unless special permission to use them has been obtained in advance. The reason for this is, that owing to the misuse of auditor's reports in the

past, innocent third parties have been repeatedly deceived, very often to their financial detriment. Unscrupulous promoters have, on occasions, published misleading advertisements in which it appeared that auditors had certified to certain facts, when they had not done so. This misinterpretation of the auditor's report was made with intent to deceive prospective investors.

Business men have granted credit upon the strength of accounts prepared by an auditor, without closely examining his certificate, and without noting the responsibility with which he charged himself for the items appearing in the report.

A business man must, therefore, respect the auditor who may take such necessary steps to safeguard his professional reputation. The client must remember that the auditor can never be sure of the purpose for which his balance sheet may be used. It follows, then, that the auditor can certify only to that which he believes to be true.

7. *Difference of opinion between client and auditor —an illustration.*—In certain instances it may happen that a serious difference of opinion will arise between a client and his auditor. The case is related of a very prominent accounting practitioner in New York City who was called upon by a client to prepare a balance sheet which was to be submitted to a bank as the basis for a loan. When the balance sheet was delivered to the client, the latter found to his dismay that the auditor represented him as insolvent. The

client was insolvent, but he had apparently reckoned in his own mind, that the auditor, in exchange for a fee, would prepare a favorable report. The auditor rendered his bill in due course and the client refused to pay it. The client subsequently submitted statements to his bankers, prepared under his own hand, in which he declared himself solvent. Shortly afterward, the client went out of business by way of the bankruptcy court, and the attorney for the principal creditors, noting that the claim of the accountant was in the list of unsecured creditors, paid the accountant's fee and secured a copy of the report.

It is evident that this information was all that was necessary to convict the bankrupt in a criminal action for obtaining credit on a fraudulent statement of financial condition. If the auditor had been paid, the client could, of course, have suppressed the auditor's report with the probability of escaping conviction for criminally uttering a fraudulent balance sheet.

8. *Graphic method of presenting financial results.*—Auditors are using, to an increasing extent, the graphic method of presenting financial facts. It is not uncommon to find, as a part of a report, a chart, showing the fluctuations in purchases and sales, or portraying the fluctuations in gross revenues, operating costs and net income.

If comparative figures for preceding periods are available, the auditor will probably prepare his report in comparative form, showing the assets and liabilities, and expenses and income, for one or more pre-

ceding periods. Probably the greatest service which the auditor can render to his client is to interpret the result of operation, and to make comparisons with preceding periods. Thus, if the gross profit on sales is less this period than last, and the turnover remains the same, the auditor should show his client the causes responsible for this business condition.

9. *Auditor as arbitrators.*—Probably not the least important service of the professional auditor is that which he may perform as an arbitrator in dispute between partners or between business men. Innumerable examples might be cited where bitter disputes and expensive litigation have been avoided thru arbitration by auditors.

If care is used in the selection of the proper type of man for a service of this kind, the results will ordinarily prove more satisfactory than those obtained by prolonged and expensive litigation. The work of preparing accounts, which are the subject matter of litigation, will be expensive for both parties to the issue. Even when the accountants have performed their tasks in matters of this kind, with all the professional skill of which they are possessed, the work may be largely nullified thru the incompetence of an attorney. Lawyers are, as a rule, ignorant of accounting to a great degree. The failure of an attorney representing a litigant to grasp the significance of the facts developed by the accountant has lost a number of cases.

10. *Is an auditor justified in relying upon state-*

ments made by the proprietors or officers of an undertaking?—As a practical matter, it is almost impossible, in the great majority of cases, for the auditor to verify exhaustively all the assets and liabilities of a business undertaking. Considerations of time as well as of expense operate to prevent such thoro investigation, however desirable it might be, and an auditor is frequently forced to rely upon the statements made by the proprietors or officers of an undertaking. The question then arises as to the liability of the auditor for negligence, if it should subsequently appear that the statements upon which he relied were false.

11. *Attitude of an English court with regard to auditors' responsibility in accounting practice.*—In a famous English case—the Kingston Cotton Mills Company case—the manager of the company had deliberately exaggerated the quantities and values of cotton and cotton yarns held by it at the end of several years. It seems that a stock journal was prepared at the end of each year showing the amount of stock on hand under the different heads. The heads were summarized, and the summary was signed by the manager. The auditors took the totals under the various heads from the summaries, but did not examine further into the accuracy of the accounts summarized.

The auditors of the Kingston Cotton Mills Company, Limited, appealed against a court order making them liable to replace to the company moneys improperly applied in payment of dividends, on the face of certain balance sheets which they had signed.

The court, in giving judgment, said that it was no part of an auditor's duty to take stock; that he must rely upon some other person for the details of an audit, and for the materials to enable him to enter it at its proper value in the balance sheet. While, as it was pointed out, the present fraud would probably have been discovered had the auditors gone more fully into all the books relating to the inventory, the question was, were the auditors lacking in reasonable care in considering it unnecessary to test the managing director's returns. On this question the court held: that, in the absence of any suspicious circumstances, the auditors could not be held liable; that they were watch-dogs, not bloodhounds; that they were justified in believing the trusted servants of the company; and that they were not to be made liable for failing to track out ingenious and carefully laid schemes of fraud, if there was nothing to arouse their suspicions. Furthermore, the court felt that to hold the auditors responsible for a case of this kind would be to make the position of an auditor intolerable.

It would seem that, in this particular case, the auditors escaped too easily, because there is apparently no doubt that the fraud would have been discovered had the auditors gone further in their investigation. Even tho, as in this case, they had qualified the inventory in the balance sheet by the phrase, "as per manager's certificate," an auditor must assume some responsibility, or else what is the object of having accounts audited?

12. *Moral responsibility of the auditor.*—From the

tenor of numerous decisions rendered in England it would seem that by qualifying his certificate and relying, perhaps, upon decisions which make his legal responsibility less onerous, the auditor is practically absolved from all responsibility in the only business in which he professes to engage. If the profession is to reach that place in the estimation of business men which it ought to hold, and if the auditor is to fulfil his economic functions to the community, he must assume a moral responsibility more exacting than his legal responsibility apparently calls for.

13. *Abuses in the profession.*—That there are abuses in the auditor's profession at the present time cannot be denied; that some auditors lack the proper conception of their responsibilities must be admitted, but the fault is not entirely with the auditor. It rests partly with the business man who fails to recognize the distinction between the right type of auditor and the charlatan. The fault also rests, to a certain extent, with state legislatures in neglecting to demand the proper qualifications from those who are licensed to practise. Investors and stockholders are thus denied the protection of the law against dishonest bankers, promoters, auditors and corporate managers to which they should be entitled. Fortunately, the loss from this laxity is not as great as it otherwise might have been, by reason of the fact that the average American business man, as well as the professional man, tries to play the game straight.

14. *Forms of certificates.*—If the auditor has made

a complete audit of the accounts and is satisfied that they disclose accurately the financial condition of the undertaking, he will attach his unqualified certificate. The form of certificate differs, and it will vary from the common one "audited and found correct," to the more elaborate type now frequently used;

I have audited the accounts of the Blank Manufacturing Company for the year ended December 31, 192–, and

I CERTIFY that the above balance sheet is, in my opinion, a true statement of the financial condition of the Blank Manufacturing Company at December 31, 192–, and that the accompanying profit-and-loss account is correct.

(Signed) JOHN DOE,
Certified Public Accountant.

An analysis of the above certicate will show that the auditor has given his unqualified approval to the accounts of the company, as disclosed by its books. No reservation or qualification has been made.

An auditor will furnish a qualified certificate when he has been limited in the scope of his investigation, or when for other reasons he has accepted the valuations placed upon assets by others, or has not actually verified the existence of, or satisfied himself as to the value of, certain assets. A common form in practice follows:

I have audited the accounts of the Blank Manufacturing Company for the year ended December 31, 192–. The inventories of raw materials and supplies, work in progress and finished products, were accepted at the valuations placed thereon by the factory manager. I have verified the extensions and footings of the inventory.

I have tested the accounts receivable by checking the subsidiary records to the controlling account, and believe that the reserve provided for doubtful accounts is sufficient to meet the losses which may be sustained in the collection thereof.

I HEREBY CERTIFY that, in my opinion, the accompanying balance sheet as of December 31, 192–, and the statement of profit-and-loss for the year ended at that date, are correct.

(Signed) RICHARD ROE,
Certified Public Accountant.

It will be noted in this form of certificate, that the auditor has qualified it to the extent of mentioning that the quantity and value of the inventories are matters for which he does not assume responsibility. He has described specifically the responsibility which he assumes in connection with the inventory, that is, that extensions and footings only have been verified. Evidently, in this case, the accounts receivable have been tested, and the reserve provided for doubtful debts is based upon the past experience of the business, or upon some other basis which the auditor believes to be correct.

15. *Importance of the auditor's work.*—The method of interpreting professional reports will be discussed in Volume 22. The reader will probably fully appreciate the economic function of the auditor in the business world of today. The requirements of the profession are exacting, and the business executive is demanding more and more of his auditor. The wide-awake executive no longer regards the payment which he makes for his auditor's fee as a

useless or as an unnecessary expense. It is his own fault if he does not receive in return value equivalent to that which he pays out. If the right type of man is employed as an auditor by the executive, and if the executive is willing to pay for the reasonable value of the services received, the investment will prove profitable. The employment of others than qualified auditors is a pure waste of money. Business men should therefore support any legislation that will tend to improve the profession, or that will tend to increase the responsibilities of those who practise it.

REVIEW

What are the duties of an auditor in making recommendations as to system, business policy or internal organization?

What are the general contents of an unqualified certificate?

What are the duties of an auditor in testifying as a witness in court?

Why would you favor legislation increasing the legal responsibilities of auditors?

What are the advantages to be obtained by the enactment of legislation requiring public companies to have their accounts audited?

Note: Numerous questions of business practice and procedure are discussed in detail in the Modern Business Reports. The current list will show those which are especially related to this volume. Among them may be mentioned

1 Inventories, Physical and Perpetual
18 Accounting Records as Legal Evidence
23 Department Store Accounting
30 An Accounting System for a Packing House
34 An Accounting System for Hotels and Grill Rooms
52 Accounting and Auditing of Public Service Corporations
65 Evaluation of Public Utilities
85 Steamship Accounting

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